BY RAJENDRA SISODIA (WITH JAGDISH SHETH)

THE RULE OF THREE IN INDIA

Prof. Rajendra Sisodia ('74 EEE) of Bentley College, and Prof. Jagdish Sheth of Emory University came up with a startling theory that may shape the future of how business leaders evaluate future strategy and visions for their companies, and also how governments look at anti-trust policy. Their view – that there can be no more than three major players in any market – has borne true in the US. Here they examine the impact of the fascinating rule of three in India. CNBC carried a mini-series based on their book.

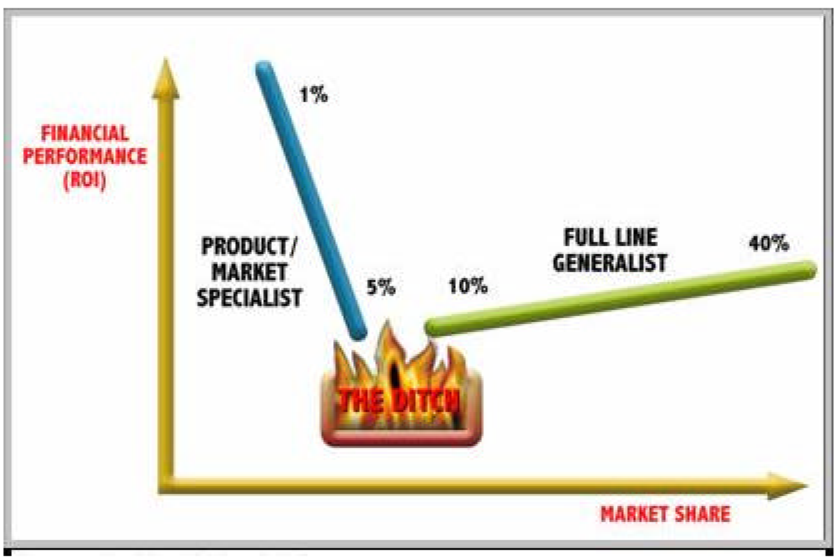
OVER the past several years, the world economy has witnessed a unique combination of economic phenomena: mergers as well as demergers at record levels. As a result, the landscape of just about every major industry has changed in a significant way. Industries are in the midst of rationalization and consolidation, moving inexorably toward what we call the Rule of Three.

Through competitive market forces, markets that are largely free of regulatory constraints and major entry barriers (such as very restrictive patent rights or government-controlled capacity licenses) eventually get organized into two kinds of competitors: **full-line generalists** and **product/market specialists**.

Full line generalists compete across a range of products and markets, and are volume-driven players for whom financial performance improves with gains in market share.

Specialists tend to be margin-driven players, who actually suffer deterioration in financial performance by increasing their share of the broad market. Contrary to traditional economic theory, then, evolved markets tend to be simultaneously oligopolistic as well as monopolistic.

The graph shows financial performance versus market share, illustrating the central paradigm of the Rule of Three: In competitive mature markets there is only room for three full-line generalists, along with several, in some markets, numerous, product or market specialists. Together, the three competitors typically control, between 70% and 90% of the market. To be viable as volume-driven players, companies must have a critical-mass market share of at least 10%. As the illustration shows, the financial performance of full-line generalists gradually improves with greater market share, while the performance of specialists drops off rapidly as their market share increases.



SOME OBSERVATIONS IN THE MARKET EVOLUTION

By analyzing the evolution of about 200 sectors, we have arrived at the following generalizations:

1. A typical competitive market starts out in an unorganized way, with only small players serving it. As markets expand, they get organized through a process of consolidation and standardization. This process eventually results in the emergence of a small handful of "full-line generalists" surrounded by a number of "product specialists"and "market specialists." Contrary to popular belief, such shakeouts often take place during market expansion (witness the cellular telephony industry in recent years).

2. With uncanny regularity, the number of full-line generalists that survive this transition is three. In the typical market, the market shares of the three eventually hover around

40%, 20% and 10%, respectively. Together, they generally serve between 70% and 90% of the market, with the balance going to product/market specialists. The extent of market share concentration among the big three depends on the extent to which fixed costs dominate the cost structure.

3. The financial performance of the three large players improves with increased market share – up to a point (typically 40%). Beyond that point, diseconomies of scale set in, along with regulatory problems related to heightened anti-monopoly scrutiny.

Credit: Bentley College

4. The big three companies are valued at a premium (price-earnings ratio) compared with smaller companies, especially those in the ditch. The oil industry is a recent example; the "Big Three" (Exxon-Mobil, BP and Royal Dutch) have P/E ratios of 15, 18 and 13 respectively, while mid-sized players Texaco, Chevron, Philips and Conoco have P/E ratios of 12, 9, 6 and 7 respectively.

5. If the top player commands 70% or more of the market (usually because of a proprietary technology or strong patent rights), there is often no room for even a second full-line generalist. When IBM dominated the mainframe business many years ago, all of its competitors had to become niche players to survive. When the market leader has a share between 50 and 70%, there is often only room for two full-line generalists. Similarly, if the market leader enjoys considerably less than 40%, there may (temporarily) be room for a fourth generalist player.

6. A market share of 10% is the minimum level necessary for a player to be viable as a full-line generalist. Companies that dip below this level are not viable as full-line players, and must make the transition to specialist status to survive; alternatively, they must consider a merger with another company to regain a market share above 10%. In the US airline industry, US Airways, Northwest and America West are all in the ditch; each will eventually have to shrink into specialty status or merge with one of the Big Three (American, United and Delta) in order to survive. Previous ditch players, such as Eastern, Braniff, PanAm and TWA, have already perished.

7. In a market suffering through a downturn in growth, the fight for market share between Nos. 1 and 2 often sends the No. 3 company into the ditch. For example, this happened in soft drinks (RC Cola wound up in the ditch), beer (Schlitz), aircraft manufacturing (Lockheed first, then McDonnell Douglas), and automobiles (previous battles between GM and Ford drove Chrysler perilously close to extinction).

8. Nevertheless, in the long run, a new No. 3 full-line player always emerges. In the globalized soft drink market currently, the combination of Cadbury-Schweppes, Dr. Pepper and 7-Up has resulted in the creation of a viable new No. 3 player behind Coke and Pepsi, with approximately 17% market share.

9. The number one company is usually the least innovative, though it may have the largest R&D budget. Such companies tend to adopt a "fast follower" strategic posture when it comes to innovation.

10. The number three company is usually the most innovative. However, its innovations are usually "stolen" by the number one company unless it can protect them. Such protection is becoming more difficult to attain over time.

11. The extent to which the third ranked player enjoys a comfortable or precarious existence depends on how far away that player is from the "ditch."

12. The performance of specialist companies deteriorates as they grow market share within the overall market, but improves as they grow their share of a specialty niche.

13. Successful niche players (product-market specialists) are, in essence, monopolists in their niches, commanding 80-90% market share.

14. Successful market growth (finding new markets for existing products) requires product strength, and successful product growth (developing new products for existing markets) requires market strength.

15. Ditch players can emerge as big players by merging with one another, but only if there is no viable third ranked player to block them. A better strategy is to seek a merger with a successful full line generalist. The ditch can be a very attractive source of bargains for full line generalists looking to rapidly boost market share.

EVIDENCE FOR THE RULE OF THREE IN INDIA

The application of the Rule of Three to the Indian market is moderated by two significant and persistent factors: the presence of a large unorganized and unbranded sector in many industries, and the presence of many regional players. While we believe that both of these factors will gradually wane in coming years (as they have elsewhere in the world), they

continue to be significant for now. Below, we highlight a few sectors in which the Rule of Three is imminent or already here.

Cement

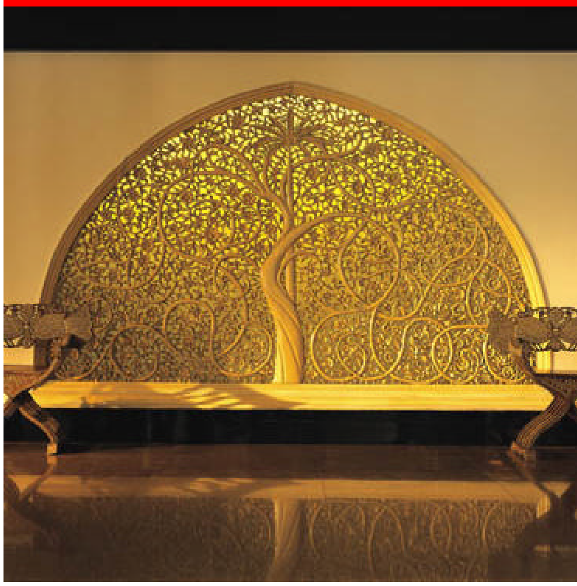
The Indian cement market, the fourth largest in the world, has become a key battleground for the world's leading cement makers: Lafarge of France, Holderbank of Switzerland and Cemex of Mexico. Of the three, Lafarge has been especially aggressive in India, acquiring the cement businesses of Raymond and Tata Steel, and is in the running (along with Holderbank and Cemex) to acquire a stake in L&T's cement business as well. Already the largest player in the eastern part of the country, Lafarge is clearly not done with acquisitions in India.

L&T and **ACC** lead the Indian market with a capacity of approximately 15 million tonnes per year each, followed by **Grasim** with approximately 10.5 million tonnes. The total capacity in the market is approximately 110 million tonnes; the current Big Three thus control only 37%. The industry remains fragmented, and many more mergers and acquisitions lie ahead.

Those domestic players that have not been selling to the global Big Three have been making rapid-fire acquisitions; Gujarat Ambuja (with plant capacity of about 8 million tonnes per year) has bought DLF Cement and Tata's stake in ACC.

Likely market specialists, focusing on regional markets, include India Cements, which is the largest producer of cement in South India, with a production capacity of 3.5 million tonnes per year.

Aluminum



The aluminum and copper industries have seen the emergence of a handful of dominant players following a remarkable phase of national and global consolidation and expansion within the industry. Aluminum manufacturing is largely an oligopolistic market with **Bharat Aluminum Company Limited** (BALCO), NALCO and **Hindalco** accounting for 88% of production. **Sterlite Industries Ltd.** - also a major player in copper - recently bought 51% of BALCO from the Government of India and a 55% piece of India Foils, the largest manufacturer of aluminum foils. Additionally, Hindalco acquired Alcan's 54.6% stake Indian Aluminum Company (IAC) in March 2000.

Hospitality

Even though the hotel industry in India is struggling, construction is booming, consolidation is looming and global players are looking for room in the struggle for control of the market. For survival, hotels in India are linking up with international chains, many of which are actively looking to acquire properties in India. Join ventures are sprouting as those with global ties seem likelier to become one of three in this competitive field.

The Indian hotel industry is an oligopoly with few key players grappling for control. They include **The Indian Hotels Company, Ltd. (IHCL or Taj Group),** the largest hotel operator in India with a 20% market share and almost twice as many properties under management as its closest rival, the **India Tourism Development Corporation (ITDC or the Ashok Group)** with a 15% market share; and **EIH** (East India Hotels) with a 12% market share. Other players include **ITC** hotels (linked with the Sheraton chain), followed by smaller entities such as **Hotel Leelaventure, Asian Hotels** and **Jaypee Hotels**. Recent acquisitions include IHCL's purchase of the Blue Diamond Hotel and its signing of a joint venture with GVK Hotels for three hotels in Hyderabad.

Copper

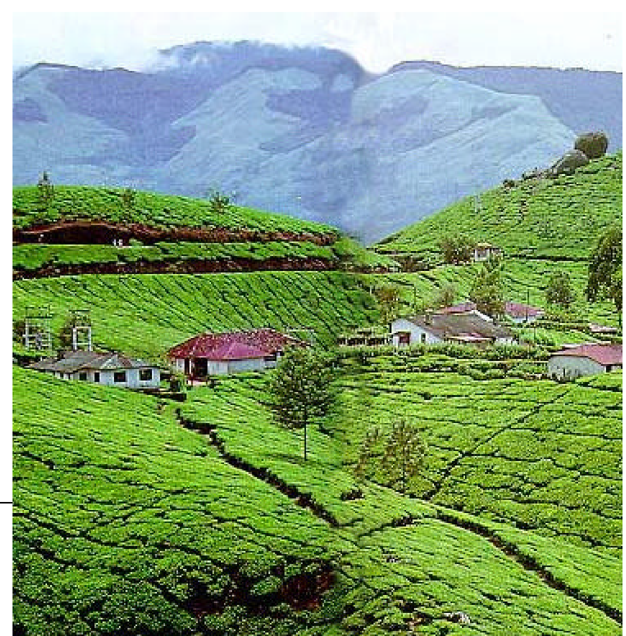
Aluminum's sister industry, copper, is quickly boiling down to the Rule of Three, following a spate of consolidations. Three major players in the organized sector currently control the copper industry: **Hindustan Copper, Birla Copper,** and **Sterlite Industries.** There are a large number of small manufacturers as well. Recently, Sterlite Industries Ltd. acquired two mines in Australia, which makes it easy to source the raw materials.

Tea

The Indian tea industry is facing a crisis in terms of consumption. This struggle is expected to end up weeding out many of the 125 small and medium-sized tea companies that exist.

There are several main companies in the industry, many of which have recently participated in mergers on both national and global levels.

Tata Tea is the leading tea plantation company in India and the largest integrated tea producer in the world. During 2000, the company acquired entire shareholding of world's second largest branded tea company, Tetley Group Limited of the United Kingdom. The Tata Tea/Tetley combination now ranks as the world's number two tea company in the world, with about 5% of sales. The purchase of the Tetley



business, which is twice the size of Tata Tea, represents the largest cross-border takeover of an international brand by an Indian firm. **Tata Tea** faces competition from **Hindustan Lever's** Brooke Bond and Lipton brands, which command a 34% market share to Tata Tea's 20%. The **Goodricke Group** and the **Assam Company** are the other major players.

Tobacco

India's cigarette market of 105 billion sticks a year is relatively small compared to China; 82% of India's tobacco is consumed in the form of beedis. However, the market is still attractive to multinationals, given its size (200 million smokers) and growth potential. The Big Three in India are **ITC** (65% of the market), **Vizir Sultan Tobacco** and **Godfrey Philips**. Philip Morris already owns 36% of Godfrey Philips, while BAT has 33% of ITC.

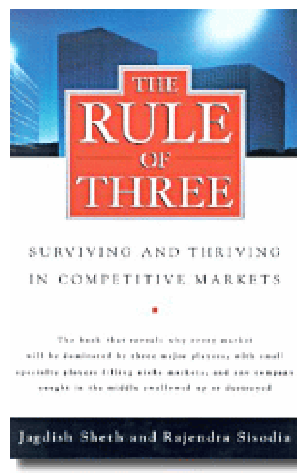
Luggage Industry

The Indian total luggage market is approximately Rs 1,200 crore annually, of which Rs 700 crore comes from the unbranded unorganized sector. Within the Rs 500 crore branded luggage market, VIP has a lion's share of 64.7%, Aristocrat (a corporate sibling of VIPs) has 16%, Safari has 12.7% and Samsonite has 6.6%. Samsonite has positioned itself as a specialist targeting the premium end of the market. Samsonite arrived in India in 1997 (CEO & Promoter with 40% market share–**Dr Ramesh Tainwala** is a BITSian) and has since captured 60% of the premium segment, with sales growing at 40% per year.

IN CONCLUSION

The Rule of Three applies wherever competitive market forces are allowed to determine market structure with only minor regulatory and technological impediments. It would, therefore, not apply in markets where Regulation, Exclusive rights (where patents and trademarks reign); Licensed economy and where major barriers to trade and foreign ownership of assets have been erected.

Ultimately, the Rule of Three is about the search for the highest level of operating efficiency in a competitive market. Industries with four or more major players, as well as those with two or fewer, tend to be less efficient than those with three major players. The role of the government is to ensure that free market conditions do indeed prevail, to allow industry rationalization and consolidation to occur naturally, and to step in when an industry seeks to consolidate too far, i.e., to a level where fewer than three players control the lion's share. ♦



ABOUT RAJ SISODIA

Dr. Sisodia is one of the first of three teacher-scholars at Bentley College. Dr. Sisodia joined Bentley from George Mason University, where he served as associate professor of marketing and director of executive programs at the School of Management. His teaching, curriculum development and scholarly activities focus on digital commerce; technology management; technology as a change agent; the telecommunications and information industries; services; marketing productivity; and the impact of information technology on marketing strategy. His work has been featured in professional journals such as the Harvard Business Review, Wall Street Journal, New York Times, Washington Post and American Public Radio's Marketplace. He co-hosted a monthly talk show on business and management issues broadcast on National Public Radio. Dr. Sisodia received a BE (Hons) Engineering degree from BITS Pilani (1979), MMS from Bajaj Institute of Management (1981) and MPhil PhD in Marketing from Columbia University (1988).