

# Prism

First Semester 2003



**Arthur D Little**

**Back to Basics**



## David vs. Goliath - Lessons from Market Liberalization since the 1990s

*Bruno Duarte and Jean Fisch*

Arthur D. Little has helped former monopolies and market entrants alike in designing strategies for liberalized markets.

Duarte and Fish draw on their extensive experience in designing competitive strategies on liberalized markets. They review typical market entry strategies as well as the way incumbents both anticipated and reacted to these threats. It is the first of two articles and focuses on the views and conclusions from a new entrant's perspective, and what they can possibly do to be successful on these markets. The second article will focus specifically on incumbents' strategies to defend their market positions

The 1990s were the boom years of market liberalization. All over the world former monopoly markets such as air transportation, telecommunications, railways, TV and radio broadcasting, and energy were deregulated by governments anticipating that the introduction of competition would bring concrete benefits to consumers in terms of price and service. Numerous new entrants saw their chance to enter attractive markets with high margins, where the incumbents were perceived as inefficient, bureaucratic and unresponsive to customers' needs. But now that the dust has settled, it appears that these new entrants have had a harder time getting a slice of the cake than had been initially expected. In fact, there are countless failures and only a few true success stories to be told. Europe's competitive fixed telecommunications and air transportation markets illustrate particularly well how diverse the performance of new entrants can be.

Whereas Telecom Italia invested several hundred million euros in its French subsidiary 9 Telecom only to end up having to pay LDCOM for taking over its loss-making subsidiary, Tele2 - with substantially less initial funding - managed to gain a 13 percent market share in France and achieved a positive cash flow in less than three years. Similarly, in the wake of the deregulation of the European air transportation sector, numerous airlines<sup>1</sup> were launched and have since gone bankrupt. Only a few like RyanAir and easyJet have successfully established fast-growing and profitable operations<sup>2</sup>

Since 1990 Arthur D. Little has gained extensive knowledge and insight into the competitive dynamics of liberalizing industries. Work carried out with both incumbents and new entrants has uncovered a number of lessons valuable to companies intending to either enter a liberalizing market or defend its dominant market position as

<sup>1</sup> Such as Debonair (UK), AirLib Express (France), Goodjet (Sweden), Berlinjet (Germany), or Ciao Fly (Italy)

<sup>2</sup> Together, RyanAir and easyJet enjoyed a 5 percent share of the European air transportation market and over €250 million of operating cash flows in 2002.

*For new entrants to faithfully bank on an “inherent cost advantage” has proven risky, even lethal.*

incumbent. This article is the first of two, and focuses on the lessons learned from a new entrant perspective. Most of these may appear to be just common business sense, and indeed they often are. But it is surprising that billions of euros have been wasted by unsuccessful companies that did not stick to these basics of competitive strategy. Based on their analysis and experience, the authors propose some difficult questions for any new entrant to answer, whether they are currently in business or planning to be. The following examples will show that chances for sustainable success are seriously jeopardized when these questions are not addressed properly.

#### **“Me-too” and the fallacy of “inherent cost advantages”**

Challengers need to establish themselves. So what do they do? Typically they tend to enter recently liberalized markets with prices clearly below those of incumbents: 20 to 35 percent discounts are not uncommon. The reasoning is simple: “Incumbents are inefficient, their payroll costs are high. We have the latest and most efficient technology and equipment. We will only need to offer the same at lower prices - incumbents will not be able to match such prices”. Yet, for new entrants to faithfully bank on an “inherent cost advantage” has proven risky, even lethal. Incumbents indeed benefit from significant assets that enable them to face down price competition, namely:

- economies of scale,
- complexity of regulation,
- opportunity for price re-balancing and cross-subsidization.

#### **Economies of scale**

Incumbents are, by definition, much larger than the new entrants and therefore tend to benefit from significant economies of scale. This is particularly true for network industries, such as telecommunications, air transportation, railways, energy or postal services, which have typically been regarded as “natural” monopolies. Overall, these economies of scale more than offset any incumbent’s high wages and sub-optimal productivity cost disadvantages.

### **Complexity of regulation**

Regulation was introduced to control incumbents' economies of scale and underlying cost advantages. High initial capital investment and low marginal costs result in such large economies of scale that there may be room for only one viable player without regulation. In the United States when Alexander Graham Bell's original patents expired at the end of the 19th century, competitive telephone companies emerged. Bell, the then dominant player, refused to connect the new entrants' customers to its switchboards and became price aggressive. Eventually, Bell drove competitors out of business or acquired them. Once the company had regained its monopoly status, it raised prices. Consequently, the U.S. government decided that telephone service was a natural monopoly and decided to regulate it in the public interest.

In the course of recent liberalization, regulations were introduced to ensure that new entrants have access to incumbents' networks on a fair and non-discriminatory basis. In practice though, the situation is more complex. For example, in fixed telecommunications, regulation focuses on giving access to the incumbent's network on a cost basis. However, the cost structure of incumbents is complicated and subject to countless accounting interpretations. In the United States there were several cases where the Supreme Court had to deal with the question of how to accurately assess incumbents' costs. While new entrants argued for long-term incremental cost, incumbents, the Regional Bell Operating Companies, naturally disagreed and advocated an approach based on historical costs. Moreover, some national authorities may have conflicting interests and, for fear of possible social and economic consequences, are not always ready to put too much pressure on incumbents.

### **Price re-balancing and cross-subsidization**

In a number of network industries, including postal services, telecommunications and energy, former monopolies' pricing policies took into account both social and economic considerations. An acceptable price level for basic services used by end consumers sometimes meant that these had to be subsidized by other services heavily used by business customers, such as long-distance telephony or

*Thanks to their larger scope, incumbents can leverage their position in markets in which they have maintained their monopoly status, to better withstand a position in a market in where they are facing fierce competition.*

industrial mail. These cross-subsidizations had to be abolished to ensure proper competition. Such re-balancing schemes significantly reduced the attractiveness of key business segments. For example, in several European countries<sup>3</sup> fixed telephony incumbents raised their subscription prices, where they maintained their monopoly status, while reducing the price of long-distance calls, which were a prime target for new entrants. Similarly, in Sweden - the only deregulated postal market in the European Union - industrial mail is now open to competition with the result that prices have decreased sharply and are now Europe's lowest. At the same time postage rates for non-competitive segments like office mail and mailbox mail have increased drastically. Thanks to their larger scope, incumbents can leverage their position in markets in which they have maintained their monopoly status, to better withstand a position in a market in where they are facing fierce competition.

In combination, complexity of regulation and price re-balancing confront many new entrants with pressure from price squeezes. On one side, complexity of regulation means that a major share of new entrants' costs are the wholesale prices they have to pay the incumbents for access to their infrastructure. For example, the price paid by a new entrant to interconnect with the France Telecom network for a 2-minute domestic call in France in 2000 still made up more than 40 per cent of the retail price. And on the other, the re-balancing of incumbents' prices leads to a reduction on retail prices. This leaves little room for profits once other costs like overhead, marketing, billing, etc. are deducted. Germany provides an extreme example. In 1999, lease prices paid by Internet Service Providers for Deutsche Telekom's local access network were 20 percent higher than line rental prices for end-users paying directly to Deutsche Telekom. Such price squeeze pressure has typically wiped out any "inherent cost advantage" that new entrants thought they might have had.

---

<sup>3</sup> In France, between 1996 and 1999, France Telecom fixed telephony subscription prices increased by 48 percent for residential and 73 percent for business customers, whilst prices for long distance and international calls (first segments to be open to competition) decreased by approximately 45 percent.

New entrants may envisage a sustainable strategy based on cost leadership, but they first have to reach critical mass. In most Western European residential fixed telecommunications markets, an alternative operator can hardly survive unless it gains 10 percent of the market. Reaching such a size threshold usually requires significant funding. Moreover, simply buying market share rarely creates any value. To sustain lower prices in the long run, new entrants need to develop a completely new business model. Successful new entrants have used innovative business strategies containing at least two of the following dimensions:

- improve market attractiveness
- optimize the business model
- focus resources

#### **Improve market attractiveness**

A number of challengers were able to drastically improve the attractiveness of the market they entered, thus limiting, to some extent, win-lose confrontations with incumbents. They achieved this by leveraging two elements:

##### 1. Stimulate market growth

Aggressive pricing can stimulate market growth depending on the price elasticity for demand. Three years after Ryanair's entry, the annual traffic has tripled on the route from Dublin to Birmingham and more than doubled on the one from Dublin to Brussels, while growth had been anaemic on these routes before.

##### 2. "Pay-me-to-play"

Some new entrants have been able to tilt the economic equation in their favour. Ryanair, for instance, focuses on secondary airports and thus benefits from regional development aid, considerable marketing support from airports and lower airport ground handling charges. In a white paper released in November 2002 regarding European low-cost airlines, Arthur D. Little estimated that such aid represented for Ryanair a cost advantage in excess of 10 euros per passenger compared to typical short-haul network carriers. Similarly, Antalis, a French would-be digital terrestrial television broadcaster, is presently negotiating with TV channels to financially

*Simply buying market share rarely creates any value. To sustain lower prices in the long run, new entrants need to develop a completely new business model.*

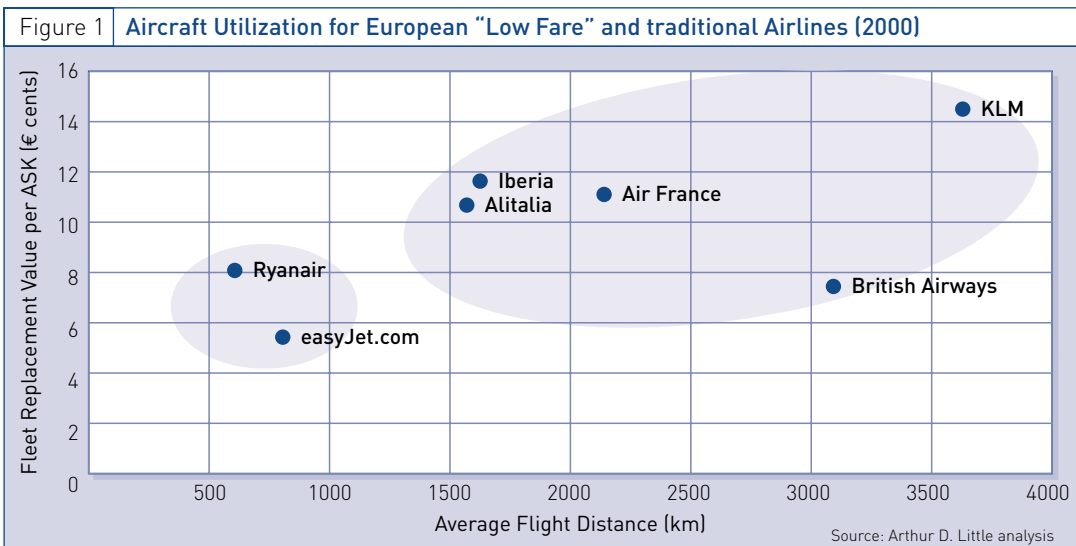
assist its market entry. The reasoning is simple: TV channels would make Antalis a credible competitive alternative to the incumbent, so that they can reap the benefits of lower prices.

### Optimise the business model

New entrants must optimize existing business models without overestimating what they can actually afford to deliver to their customers.

### Challenge the wisdom in the industry

New entrants usually pay lower wages than the incumbents, but this alone hardly leads to significant cost advantages. To compete on a low-cost basis, challengers must question the conventional wisdom of their industry. For example, low-cost airlines Ryanair and easyJet have turned their back on the traditional hub-and-spoke model of incumbent carriers. Their point-to-point service has allowed them to optimize their asset turnover, which is key in such a high fixed cost business. Thanks to better aircraft utilization than their larger counterparts, they have managed to achieve 35 to 80 percent more available seat-km (ASK) capacity for every dollar invested into aircraft leasing or acquisition. Overall, mainly thanks to higher labor productivity and extreme procedural simplicity, they have achieved unit costs as much as 60 percent lower than those of more conventional scheduled airlines.





Most importantly, the "low fare - no frills" marketing positioning of Ryanair and easyJet is fully aligned with such an operating model.

### **The better may be the enemy of the good**

New entrants often define themselves by the value of their product(s). *"What do I bring to customers compared to the incumbent? Lower prices? Higher quality and service differentiation?"* A number of new entrants have tried to position themselves with both lower prices and better service. To a certain extent, this is the case with Southwest. The company has one of the best cost structures among U.S. airlines. Also, its optimized business model has led to Southwest being consistently ranked among the best in terms of punctuality and passenger satisfaction.

But in many instances new entrants have gone far beyond what their business model and operational performance actually allowed. Debonair for example, a UK-based "low-cost" airline was launched in 1996. Despite a successful £28.2 million IPO in July 1997, the company went bankrupt in September 1999. As competition with other low-fare airlines such as easyJet intensified, Debonair progressively abandoned the key features of the low-cost model. To gain market shares Debonair decided to offer generous seat pitch or complimentary onboard refreshments, and to intensify its indirect sales through travel agents. This led to higher costs and blurred its image as a low-cost airline, with the result that the company came under further pressure. And Debonair is not the only example. In the same manner, British Airways attempted to reposition Air Liberté, the fledging French airline it took over in 1997, from "low fare - no frills" to a high quality carrier - and failed. BA had to sell off its subsidiary three years later.

### **Focus resources**

In a number of markets, such as telecommunications, energy and air transportation, incumbents are traditionally vertically integrated and cater to all customer segments. Most new entrants that merely replicated this model have performed poorly, as this leads to a significant resources drain without necessarily generating any competitive advantage. This is exactly what the foreign subsidiaries of telecom incumbents like KPN Belgium or

*Some new entrants have successfully focused their resources on a single step of the value chain and/or on a specific customer segment. This is particularly relevant in commodity markets with high fixed costs where focusing resources allows companies to reach critical mass more effectively.*

9Telecom (the former subsidiaries of KPN in Belgium and Telecom Italia in France) faced. Similarly, the failure of the domestic low-cost carriers of large U.S. airlines, such as Continental Lite, Delta Express or Shuttle by United can to some extent be explained by their difficulty escaping the influence of their parent-companies.

On the other hand, some new entrants have successfully focused their resources on a single step of the value chain and/or on a specific customer segment. This is particularly relevant in commodity markets with high fixed costs where focusing resources allows companies to reach critical mass more effectively. Such a focus usually is in line with the optimization of the new entrant's business model, as resources are put to use where competitive differences can be developed. For example, Tele2 in France focused most of its resources in client-related value steps for the mass-market, and invested very little in telecom networks. Over the past three years the company consistently invested 3 to 5 million euro per month in advertising. At the same time, the company limited its marketing staff to a minimum<sup>4</sup>. Interestingly, while many telecommunications operators have outsourced all or part of their call centers since they consider them a non-core activity, Tele2 has kept them mostly in-house, consistent with its resource focus on client-related areas.

New entrants naturally tend to focus on attractive market segments. Typically, in areas with high customer density, incumbents' margins may be artificially high to make up for the low prices in less attractive regions. This usually is the result of monopolies' universal service obligation, to provide service to everyone in the country. New entrants to these attractive segments benefit from the opportunity to undercut such abnormally high prices. This was exactly the driving force behind CityMail's entry in 1991 in the liberalizing postal market in Sweden. The challenger of Swedish Posten focused on industrial mail for delivery in highly populated areas, namely greater Stockholm, inner Malmö and Gothenburg. CityMail was able to operate with less than 1,000 postmen compared to more than

---

<sup>4</sup> Tele2's marketing department in France is made up of less than 10 people, compared to more than 40 at new entrant competitors.

17,000 for Swedish Posten<sup>5</sup>, as it benefited from a much lower number of collection points, from delivery addresses concentrated in high density areas and from sticking to industrial (i.e. non urgent) mail. CityMail promoted aggressive postage rates and subsequently gained a 30 percent market share of its targeted segment.

It is not enough, though, to identify and simply focus on attractive segments. Companies also have to take the dynamics of the competitive environment into account. Targeted segments must be chosen so as to limit the ability for the incumbent to retaliate. In the case of CityMail, its strategy had one Achilles Heel: namely the assumption that Swedish Posten would not follow suit. The incumbent, however, ultimately fought back aggressively, partly in the context of price re-balancing. Similarly, the introduction of yield management in the mid-1980s allowed American Airlines to match the low fares that new entrants such as People Express charged, without slashing prices across the board. Also the possibility that other challengers might enter the fray needs to be anticipated, as attractive segments without true entry barriers rapidly tend to become overcrowded with newcomers.

### **Haste or the fallacy of the “time-to-market” imperative**

Timing is an essential element for the success or failure of new entrants. Misjudging the required time-to-market is usually a sure death sentence. Arthur D. Little’s work with prospective new entrants and financial institutions considering backing them have often shown how inaccurate many business plans were as a result of over optimistic top-line growth assumptions. It indeed takes much longer than initially anticipated by new entrants to gain market share. Take the telecommunications sector in Europe. Five years after the liberalization of fixed telephony in Europe started, most incumbents still have a market share of well over 60 percent. Challengers have regularly underestimated incumbents and “gambled” on the former monopoly’s inertia or inability to retaliate. In addi-

---

<sup>5</sup> CityMail operated less than 200 collection points (more than 7,000 for Swedish Posten), served app. 1.2 million addresses (app. 4 million for Swedish Posten), with one distribution round every three days while 95 percent of Swedish Posten mail was delivered within a day.

tion, new entrants tend to forget that, even in commodity businesses, the quality of their value proposition to prospective clients is only one aspect driving customer acquisition. Other marketing mix elements such as promotion, awareness or distribution are easily overlooked. New entrants eventually acknowledge this market share inertia, as the following comments illustrate: “we have the cheapest offer in the market... but nobody knows” or “clients don’t bother with the hassle of switching suppliers”.

Still, time-to-market is often a driving force behind the business plan of many challengers. In most markets, new entrants understand that there may only be room for a few viable players alongside the incumbent, who usually keeps the lion’s share. For example, in fixed telecommunications, at the most two full-fledged alternative operators are expected to survive in each European country in the long run. New entrants perceive this as a strong incentive to pre-empt competitive positions by rushing to the market. In network type industries, this incentive is reinforced by the fixed cost nature of the business and has often led new entrants to be obsessed with filling up their spare capacity as soon as possible.

However, numerous examples illustrate that time-to-market is not always a recipe for success. In France, Cegetel launched its mass market fixed telephony service offerings more than a year prior to Tele2 and still trails behind in terms of market share and profitability. In Australia, Compass in the early 1990s was the first airline to launch a domestic low-fare service, but it collapsed after less than two years in operation. A mistake often made is to sacrifice “first-time-right” approaches on the altar of a perceived “time-to-market” imperative. An early market entry needs to be carefully assessed in the light of how mature the “rules of the game” are and the readiness of the new entrant’s value proposition.

#### **“Rules of the game” maturity**

Numerous new entrants have suffered from an overly early entry in liberalized markets, when regulation was still in its infancy. As we have seen, the way regulation “matures”, in terms of interconnecting prices or price rebalancing, has a direct impact on the price squeeze felt by

new entrants, and therefore their sustainability. Moreover in situations favorable to “pay-me-to-play” strategies, a new entrant obviously ought to receive strong commitment from its potential backers prior to investing significant resources. It sounds trivial, but the example of Holland Sweetener Company (HSC)<sup>6</sup> demonstrates that it is easily neglected. Upon Monsanto’s aspartame patent expiry in 1987, HSC entered the market with an aggressively priced generic product. Ultimately, major aspartame clients profited the most from HSC investments in this market. Leveraging on the possibility to switch their purchases to HSC, Coke and Pepsi were able to negotiate renewed long-term contracts with Monsanto, worth annual savings estimated in excess of \$200 million. HSC did not fare as well, and probably never recouped its initial market entry investment. HSC first invested in production capacity and initiated a downward price pressure before obtaining any tangible commitments from major aspartame purchasers.

#### **Readiness of the value proposition**

U.K. mobile telephony provides a striking example of how hastiness can work to the detriment of “first-time-right”. In September 1993, One2One, now re-branded T-Mobile, “won” the race to launch before Orange<sup>7</sup>. The company managed to do so at the expense of wide geographical coverage and unsatisfactory communication quality. Years later, the company still suffers from customers’ perception of having a poor network performance. Paradoxically, Virgin Mobile, which uses One2One telecommunications infrastructure as a “virtual network operator”, was elected “best-network-operator” by consumer associations in 2000. Virgin Mobile, which was launched much later<sup>8</sup>, leveraged its strong brand and proprietary retail shops, as well as One2One’s then much improved network.

---

<sup>6</sup> For a more detailed account of HSC entry in the aspartame market, refer to Competition (Nalebuff and Brandenburger, 1996).

<sup>7</sup> Orange commercial launch in the UK occurred in April 1994.

<sup>8</sup> Virgin Mobile was launched in the UK in November 1999.

### **Insights for the Executive - successes don't come by chance**

When deregulation comes, markets usually are turned upside down for a while. New positions may be taken and fortunes can be made - but these new ventures are usually full of risks and uncertainties like demand (or switching propensity) risk, regulation risks, and technology risks. Any venture capitalist knows that among ten ventures, he has to expect only one big success, three average corporate stories and six failures. The big difference with other ventures is that the experience and the lessons learned that we have described here should help new entrants avoid some mistakes and better assess and manage these risks, thereby increasing significantly their chances of success. It is particularly important to know that there is no "one-size-fits-all" approach concerning how to enter recently or soon to be deregulated markets. Since new entrants are usually much smaller than incumbents and have less funding, they need to be more creative. Creative in the way they optimize the existing business model of an industry and in the way they allocate the limited resources that they have. Most of all though, new entrants should not take it for granted that incumbents are immobile behemoths unable to react quickly to market changes. Their decade long existence gives them stamina and profound understanding of the market.

Companies either considering to invest in deregulating markets or having already done so should ponder the following questions concerning strategic and implementation intent.

#### **Strategic Intent**

- Are we improving market attractiveness - for the industry and for ourselves?
- Are we focusing our resources and generating critical mass in the chosen steps of the value chain and in the relevant customer segments?
- Are we reinventing the business model of the industry and at the same time limiting incumbents' room to retaliate?

### Implementation Intent

- Have we set the procedures and timing in place to be first-time-right?
- Have we ensured the commitment of our teams to stick to our recipe for success?

Arthur D. Little's experience shows that if the answer to most of these questions is "no", the plans for entering a new market should be revised.

However, as a concluding comment, we would like to make clear that the notion of success that we have addressed here is based on sustainable business success. Many new entrants have been extremely successful, but are no longer in business as independent companies. They were sold at the right time creating fortunes for their shareholders. Success is in the eye of the beholder.

#### *Bruno Duarte*

*... is an Associate Director of Arthur D. Little in France. He works on strategic and regulatory issues in liberalizing markets. His clients include major players and new entrants in the telecommunications, broadcasting, transportation and energy industries across Europe. He lectures Applied Business Strategy in leading universities in France, including Telecom Paris and Supaéro Toulouse. Duarte holds an Engineering degree in Electronics from Supelec (France) and an MBA from INSEAD.*

#### *Jean Fisch*

*... is a Director of Arthur D. Little in the Benelux. He has helped many incumbents and new entrants develop and implement winning business strategies in liberalizing markets. Mr Fisch focuses on telecommunications, electricity and gas industries. He holds a PhD. in physics from the University of Brussels and a MBA from the University of Leuven.*