A Dangerous Time to Be a Niche Player

For niche companies, years of growth can quickly turn into losses when facing industry consolidation, and a wobbly economy is only increasing the peril. As Fritz Kroeger, Andrej Vizjak and Mike Moriarty write in this adaptation of their recent book, *Beating the Global Consolidation Endgame: Nine Strategies for Winning in Niches* (McGraw-Hill, 2008), long-term success is reserved for niche companies that truly understand the playing field.

A niche company's strategy and the reality of how well it executes that strategy couldn't be further apart. Many niche players are able to feign success just because no marauding consolidator has been breathing down their necks lately. Yet with a still-weak dollar and market valuations at historically low levels, the risk of consolidation has never been greater. Even the most successful niche companies, including Apple, Ducati, Red Bull and Swatch are vulnerable. Indeed, the recent $700 billion transfer of assets could be interpreted as

a gesture in favor of reinvestment in acquisitions—something several companies have already started to do.

Friendly and unfriendly takeovers are around every corner. It doesn't take an acquisition to put you out of business. As industries consolidate, niche companies are increasingly at risk of being pushed out by bigger players or becoming prime acquisition targets. While General Motors registers a 47 percent drop in monthly car sales compared to last year, almost 1,000 car dealerships of all stripes will bite the dust in the United States this year. When Wal-Mart grows 8 percent, that means $16 to $18 billion worth of niche players just got consolidated—whether they were acquired or not.

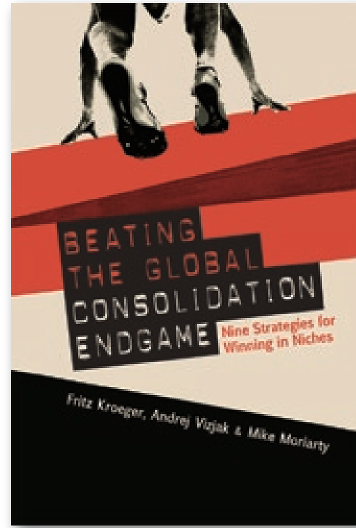
In light of this fairly routine parade of failures, we have to ask the executives of these companies whether their niche strategy has legs. Not all strategies are created equal and, as we have seen, most niche strategies are untenable in the longer term or even the short term.

The fact is that with the alibi of a niche strategy, a lot of management's failures and mistakes are concealed. Low growth, inappropriate market segments, inadequate penetration, disadvantages of scale and high costs are all explained away with statements such as "we're a niche" to divert attention from their own strategic disorientation.

Niche Matters

The concept of a niche is inaccurately thought of as being indefinable. Not many people are quite sure what a niche is. Is it simply a subsidiary market with special needs that can be served by special companies? Or is it actually a market that is too insignificant for the sector leaders to care about?

Since approximately 600,000 companies worldwide are affected by the subject of niche



Beating the Global Consolidation Endgame: Nine Strategies for Winning in Niches

by Fritz Kroeger, Andrej Vizjak and Mike Moriarty (McGraw-Hill, 2008).

strategy, this topic should be a major concern as global consolidation occurs.

However, this is clearly not the case. Even if Michael Porter were to raise the respectability level of a niche strategy, few researchers and strikingly few practitioners have considered the subject, and even Porter treats it as a carnival sideshow to the global three-ring circus.

In addition to many underestimates by business pundits, hardly any other group of strategies has misled business owners and managers in such a fatal way as an unsuccessful or poorly defended niche.

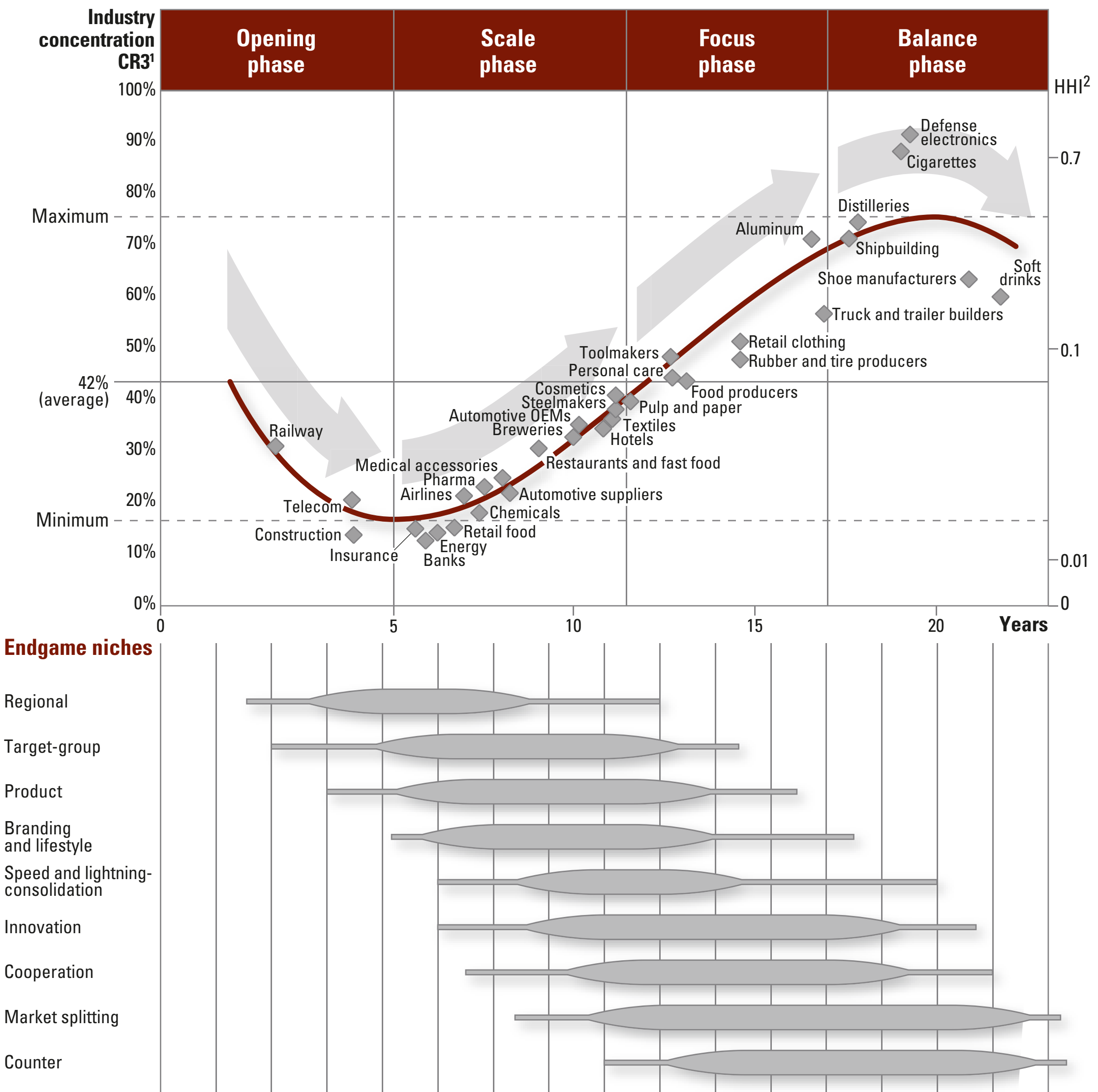
Our empirical research over the past 15 years, however, identifies how niche strategies work within the framework of global consolidation, which strategies work when, and when these strategies cease to become effective. The results of our work, and the numerous case studies that illuminate it, form the basis for *Beating the Global Consolidation Endgame.*

After years of studying mergers, we discovered that every industry follows four phases of consolidation—opening, scale, focus and balance—and each industry sector will ultimately be dominated by just a handful of companies.

Further research of more than 600,000 small- to mid-sized private companies helped us identify nine niche strategies that consistently thrive in the face of consolidation *(see sidebar: Nine Stable Niche Strategies on page 44)*. Each is a powerful strategy for success, but each is most powerful at particular points in the consolidation process. Figure 1 illustrates the consolidation curve and where on the curve each niche strategy has the best chance of success.

FIGURE

Consolidation curve and niche strategies



[1] CR3 = market share of the three largest companies of the total market based on the Value Building Growth database (660,000 companies)
[2] HHI = Hirschman-Herfindahl Index, which corresponds to the sum of the squared market shares of all companies and is greater than 90%; the axis is logarithmically plotted
Sources: Value Building Growth database; A.T. Kearney analysis

With this in mind, let's look at two examples from the automotive industry: Rolls-Royce and Porsche. Don't be concerned that the dates are long ago, but think instead of the strategic decisions that were made—or weren't made—at each key juncture.

Rolls-Royce Outgrows Its Niche

Rolls-Royce was established in 1906 by Charles Stewart Rolls and Frederick Henry Royce, who wanted to produce cars exclusively for the highest luxury class in an already widespread market within the automotive industry. Pursuing a product/target-group niche strategy based on manufacturing a special product and reaching a specific target group was an appropriate move, given that the automotive sector was just coming out of its opening phase and entering its scale phase. The founders enjoyed rapid success, and for many decades Rolls-Royce was the vehicle for a very specific audience—not only of royalty and popes, but also dictators and leaders of the underworld. Today, old models are conserved like museum pieces and brought out, cleaned, polished and displayed for connoisseurs. After World War II, however, the company took a beating, as its target market—society's wealthy—was hit hard financially. Because Rolls-Royce clung to its niche strategy, it tottered on the brink of bankruptcy, which ultimately became its fate in 1971.

In that year, this traditional U.K. company was nationalized. After many ups and downs, it was acquired in 2003 by BMW. At the time, nothing remained of the automobile legend except the brand name, which still had broad value. Rolls-Royce's technology, which had been light-years ahead at the company's inception, was now four decades behind. That same year, BMW brought out the Rolls-Royce Phantom, with an interior that integrated current BMW technology. A master product/target-group niche company, BMW essentially found Rolls-Royce by the roadside and replaced the engine, hydraulics, tires and suspension—everything except the Rolls-Royce look and name.

> As industries consolidate, **FRIENDLY AND UNFRIENDLY TAKEOVERS ARE AROUND EVERY CORNER.** It doesn't take an acquisition to put you out of business.

Did Rolls-Royce management make a fatal mistake? Not really. It just sold out 40 years too late. Or maybe management's mistakes did lead to Rolls-Royce's demise. If companies follow a niche strategy, their cash-out value should always be one of their key performance indicators. But Rolls-Royce exploited an early-phase niche—the target group—and rode it far too long. The company provides a dignified, but rather sorry, example of the failure of niche strategies.

Staying in the automotive industry, let's look at another example—Porsche. Porsche was established in 1931 as a pure sports car supplier. In its first few years, the company achieved a brand name as strong as Rolls-Royce's, but only in the sports car market—

again, a good strategy early in the consolidation of the automotive industry. In addition to producing its own cars, Porsche initially developed cars for the newly established Volkswagen group, and over the years it weathered crises similar to Rolls-Royce's. However, Porsche profited from a very stable owners' group whose members identified themselves with the company and the brand even in times of crisis. This was the beginning of Porsche's transformation from a target-group strategy to a brand and lifestyle strategy.

Since 1992, Porsche has achieved textbook-like success with a step-by-step expansion strategy that allowed the company to evolve from an initial, narrowly defined niche to a diversified product range. Porsche went from being purely a sports car supplier to producing other types of cars, including a four-seat sports limousine now in the works. Whether Porsche can hold on as an independently owned company for the long term or will ultimately require a larger parent company remains to be seen. The recent cross-holding with the Volkswagen group seems to point in the latter direction.

The now-tabled discussions between GM and Chrysler—and the exclusion of Ford—illuminate the slow flight of bullets aimed

Nine Stable Niche Strategies

We analyzed more than 600,000 private companies and identified the following successful niche strategies. Each is most effective at particular phases of industry consolidation.

Regional. These companies have a solid understanding of customers in a clearly defined regional market. German beer maker Jever Pilsner is an example of a regional niche leader.

Target group. Luxury hotel chains, such as Four Seasons, exemplify this strategy. They target certain customer segments and deliver extensive personalized services.

Product. Companies in this niche excel at providing a specific product. Cable network CNN was successful in this niche before becoming part of Time Warner.

Branding and lifestyle. Luxury labels such as Porsche and Montblanc combine the power of target-group and product niches to create communities of dedicated customers who value the brand name.

Speed and lightning consolidation. The dot-com boom highlights this niche, in

which companies grow fast and cut out the current market leaders. Examples are Facebook and Amazon.

Innovation. Innovative products, such as those from Apple and Logitech, give these companies a strong market position.

Cooperation. Smaller companies form alliances to compete against large-scale leaders. Ace Hardware and the Star Alliance of airlines are good examples of cooperation strategies.

Market splitting. These niche players take advantage of weaknesses in the value chain. When IBM split the market by dividing its IT offerings into separate, distinct markets, it became a leader in this niche.

Counter. Counter-niche companies exploit the weaknesses or strengths of the sector leaders, forcing the leaders either to alter their strategies or risk allowing the niche company to swim in the slipstream. Counter-niche companies include Japanese automakers and NetJets.

right between the eyes of companies that thought they were global consolidators, but turned out to be just another milepost on the road to the consolidation endgame. Chrysler had its government bailout long before it was fashionable, tried its "friend" relationship with Daimler and now has its run with the private-equity folks. GM, long thought of as the global consolidator, is finding that its U.S. lineup and operation create a dead weight that can't compensate for the fact that more Buicks are sold in China than in the United States.

These disasters have been rolling toward Detroit for 30 years. This is why we say there is a terrific gap in the strategic literature on this topic.

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The Foundation of Consolidation

Consolidators and niche companies alike must remember the following points:

A company's claims and reality are two different things. Guaranteed survival and success in niche markets have been achieved only by a few companies. The overwhelming majority have not survived—and will not survive. Our merger endgame theory posits that 90 percent of the companies in existence today will not be around in 25 years.[1] The inexorable impact of borderless capital, people, communications and logistics will wipe out most of the niches that were previously thought of as safe.

Too many executives lull themselves and their companies into complacency. False confidence can lead to fatal strategic blunders. The merger endgame theory predicts that industry sectors will go through their consolidation life cycle in 25 years.

The relevance of the niche problem is immense. The majority of companies will sooner or later succumb to the unavoidable juggernaut of global consolidation. Just for the record, we aren't particularly happy about this trend. But having studied the empirical evidence for the past 25 years, we can only advise our business clients to accept it as a matter of fact. As much as we may all love small companies such as Ben & Jerry's, the fact is that everything is consolidating. The 600,000 niche companies that exist today need to take notice.

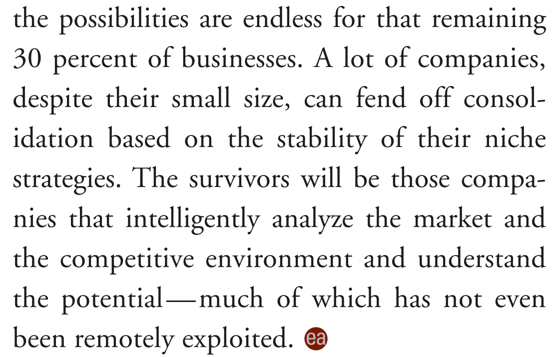
There is almost no business literature on this issue. Too many stories abound of Davids beating Goliaths, or of conglomerates sweeping away all the great small businesses in their path. We do not claim a moral high ground on either side of the issue. For every niche company, there is a time to fight the game and a time to sell. For every global consolidator, there are hundreds—even thousands—of

[1] *Graeme K. Deans and Fritz Kroeger,* Winning the Merger Endgame: A Playbook for Profiting from Industry Consolidation, *New York: McGraw-Hill, 2002.*

acquisition opportunities clamoring for attention. Global businesses require a stronger foundation on which to make their decisions.

Niche Opportunities

Global consolidation will conclude with about 70 percent of global market share in each industry held by three or four companies, but



the possibilities are endless for that remaining 30 percent of businesses. A lot of companies, despite their small size, can fend off consolidation based on the stability of their niche strategies. The survivors will be those companies that intelligently analyze the market and the competitive environment and understand the potential—much of which has not even been remotely exploited.

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Learn more about Beating the Global Consolidation Endgame *at www.atkearney.com.*