What drives market share profitability?

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Researchers from University of Alabama and Indiana University published a new paper in the *Journal of Marketing* that examines why a market share-profit relationship exists and how this understanding can be used to explain the very large difference in the value of market share between firms and across industries.

The study, forthcoming in the *Journal of Marketing,* is titled "Examining Why and When Market Share Drives Profit" and is authored by Abhi Bhattacharya, Neil Morgan, and Lopo Rego.

Recent research supports the use of market share for goal setting and performance assessment by indicating a modest but significant average positive relationship between market share and firm economic performance. In this study, the researchers use a large sample of firms operating in a wide variety of markets, measures of both revenue and unit share, different definitions of the firm's "market" in computing market share, and different econometric approaches to provide the first direct empirical assessment of the three primary causal mechanisms that have been theorized to link market share with firm profits—market power, firm efficiency, and signaling unobserved quality.

They show that, on average, most of the variance in the market share-profit relationship is explained by the market power (firm's ability to raise prices) and quality signaling (reducing customers' quality uncertainty with respect to the firm) mechanisms, with less support for the learning effects (experience effects increasing firm operating efficiency) mechanism. They also show that these causal mechanisms can be used to explain and predict the very large differences that exist in the market share-profit relationship across different types of marketplaces and firms. In addition, two conditions are identified under which market share is negatively related to firm profits: "niche" strategy firms and when firms "buy" market share.

The research shows that these same three mechanisms explain the market-share profit relationship even in these conditions where it is negative. For policymakers, the study provides new insights into when market share may lead to market power and potential abuse that requires regulation. As Bhattacharya explains, "We show that firm profits from market share arise via quality signaling and learning-based efficiencies

as well as market power.

Thus, policymakers should not directly equate market share and market power. While they are often related, they are far from synonymous." Morgan adds that "These results indicate that regulatory authorities can be less concerned by a firm's market share in marketplaces in which customer quality uncertainty is significant and where efficiency-enhancing learning benefits from market share may exist, young firms and service firms, for example. In such conditions, market share could enhance rather than harm consumer welfare by reducing consumer-firm information asymmetry and potentially lowering costs."

This new understanding of these mechanisms linking market share with firm profits is also important to managers given the widespread use of market share as a marketing performance measure. "Our results show where and why managers may be more or less advised to rely on market share to set marketing goals and monitor marketing performance—including when doing so can even lead to lower firm profits," says Rego. The study also provides new insights on when managers would be advised to pursue market share.

For younger firms and for non-banking services firms, it may make sense to set market share goals and monitor performance. It may also be more beneficial for firms operating in marketplaces with high levels of quality uncertainty and those with higher customer switching costs. However, it makes less sense for banks and firms in industries in which pricing power is low and/or quality is relatively certain. Older firms may also find market share to be of less value as a performance metric. Firms pursuing a niche strategy should either ignore market share or ensure that they assess it only within their selected niche market definition. Additional practical insights include:

- Never use unit market share measures—Although widely used in

practice to set marketing goals and monitor performance (e.g., auto and motorcycle manufacturers, many consumer packaged goods companies), results reveal that unit (volume) market share is not predictive of firm profit.
- Revenue market share—when market share's value is indicated by the presence of one or more of the three mechanisms, set goals and monitor performance using revenue market share because this does predict firm profits.
- B2C Product and B2B Service firms should set goals and monitor performance using absolute revenue market share metrics because this is the strongest predictor of firm profit for these types of firms.
- B2C Service and B2B Product firms should set goals and monitor performance using revenue market share relative to the "Top 3" market share firms in their industry metrics because this is the strongest predictor of firm profit for these types of firms.
- Even in industries where market share predicts profits, do not "buy" market share (i.e., lower prices to gain market share)—Results show that even though firms do this infrequently, "buying share" is not a profitable move.

More information: Abhi Bhattacharya et al, EXPRESS: Examining Why and When Market Share Drives Firm Profit, *Journal of Marketing* (2021). DOI: 10.1177/00222429211031922

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