Illustration 14.2
Advantages of Established Firms and Strategic Behavior

We will emphasize that brand loyalty and the reputation enjoyed by a dominant firm can erect barriers tot he entry of new firms into a market. But the strength of these barriers depends in large part on the behavior of the dominant firm. In this illustration we look at the strategic behavior of two firms that dominated their markets. They reacted differently to the threat of entry with markedly different results.

In 1981, International Business Machines Corp. (IBM) introduced its Personal Computer (PC) for $2,205. Although other companies made similar computers, IBM's PC dominated the market, particularly the business market.

One reason for IBM's domination was name identification—the advantage of being the established firm. As long as the name IBM was on the box, people weren't intimidated. Another reason for its domination was that IBM used a copyrighted basic input output system (BIOS) chip to control the way the computer talks to the screen and peripheral equipment. Thus IBM had two important barriers to entry: the advantage of being established and a patent. These barriers didn't stand very long, however.

In 1984, IBM had approximately 80 percent of the personal computer market. But by March 1986, IBM's share of the market had, for the first time, fallen below 50 percent (to 45%). New entrants had reduced IBM's market share significantly. Dozens of IBM clones—machines virtually identical to IBM's standard PC—were readily available and selling for as little as $500 (less than one fourth of IBM's suggested retail price). These clones were made from parts manufactured in the Far East and assembled in the United States. Many of the parts were practically identical to those used by IBM.

Some people did think that the clones were inferior to IBM's machines, but far more did not. And certainly the clones were much cheaper, even though many dealers were cutting the price on IBM's PC. Not only did the clones cut heavily into IBM's share of the home computer market, but its share of the business market declined as well.

What happened to IBM's barriers to entry? ***Newsweek*** suggested two reasons for the decline.* One reason was, in part, that IBM was a victim of its own success. Its PC was so popular at first that competitors realized they would have to build machines that could use software and peripheral equipment made for the PC. Also, as more PCs were sold, people became more computer literate, and IBM no longer had its original mystique. And, of course, there were the lower prices of the competition.

But, the only way to make a true IBM clone was to develop a BIOS chip that acted like IBM's without violating the copyright. Compaq developed such a compatible chip and became a half-billion dollar company.

Nevertheless, IBM would probably have been able to hold on to most of its share of the market had it been willing to cut its prices while it still dominated the market. As ***The Wall Street Journal*** reported, "Judging from the rock-bottom prices of the 'no-name' clones, both manufacturers and retailers have been operating on sales margins often exceeding 50 percent." Entry would have been discouraged by lower IBM prices. People would have been willing to pay some premium for the IBM PC, but many were not willing to pay the premium that then existed in the market.

Barriers to entry, such as those enjoyed by IBM, can protect a dominant firm with considerable market power for only so long. In the absence of strict licensing restrictions, to maintain a dominant position in a market a firm must generally continue to improve its product and keep its price low enough to discourage entry.

We turn now to another firm, American Telephone and Telegraph (AT&T), that dominated its market, but reacted differently to a severe threat of competition. From 1984 until September 1986, millions of Americans cast their ballots to decide which long-distance telephone company they would choose. Before the breakup of the AT&T Bell system in 1984, AT&T had a market share of 90 percent. Many analysts predicted that the company would suffer a drubbing in the balloting, some predicting a decline in share to as low as 60 percent. The theory was that people would desert AT&T in droves once federally mandated "equal access" enabled them to enjoy cheaper service without having to dial extra digits.

It didn't happen. AT&T held an estimated 80 percent of the market. Competitors such as MCI and Sprint made some penetration into AT&T's success: brand name familiarity and the company's marketing strategy.

One half of the respondents, in a poll conducted by ***The Wall Street Journal/***NBC News, who expressed a preference for one of the phone firms cited familiarity with AT&T as the most influential element in their choice. The poll indicated that a quality of service was the most important factor in choosing a long-distance company for 47 percent of the respondents; cost of service came in second with 25 percent. A research analyst with the Gartner Group concluded, "People will pay an extra buck or two a month for a known commodity."

So AT&T succeeded to a large extent because of its advantage of being established for so long and its reputation for quality. But, according to the chairman of MCI, "…most of AT&T's competitors failed to make the capital investments necessary to wrest large chunks of business away from AT&T." ***The Journal*** pointed out, however, "…AT&T didn't succeed solely because of the weakness of its competitors. To the amazement of naysayers, it transformed itself into a marketing powerhouse…"

AT&T went after heavy users with special pricing packages and such incentives as discounts on restaurant meals and exercise classes. It took to the airwaves with a series of TV commercials featuring the actor Cliff Robertson, who stressed AT&T's quality and reliability and suggested that its competitors weren't up to snuff. The company went so far as to prepare special materials to appeal to such diverse markets as military personnel, people in the process of moving, and various ethnic groups.

Certainly AT&T lost some customers in the balloting. Some reacted like one person who picked MCI, "I don't like AT&T. I think it's a monopoly." One analyst described many people who switched as "people who hate the corporate giant" or "people who drive foreign cars." She described people who stuck with AT&T as "risk averse," "traditionalists," or "those who drive American cars."

In addition to its marketing blitz, AT&T kept its price low enough to reduce the gap between its price and competing companies. At one time it was possible to lower a family's long-distance bill by as much as 50 percent a month by using another company. By 1986, AT&T narrowed the price difference to the 10 percent range. This wasn't enough to offset the brand loyalty and reputation for quality for a large number of people.

Thus AT&T had a great advantage over its competitors from being the old, established firm. But it was not content to rest on its laurels and exercise its considerable market power, relatively well protected by a substantial barrier to entry. AT&T's strategy was to market that reputation for quality and remain competitive in price. Sometimes a firm retains its market power by not exercising it.

Many of you will probably never manage a corporate giant like IBM or AT&T, at least not for a while. Yet the manager of any firm with market power, and that includes a huge percentage of the firms in the United States, should heed the lessons of these two examples. A firm's success depends on the strategic behavior of its managers and how they react to competition or potential competition.

*Dog-Eat-Dog Shakeout," ***Newsweek,*** May 19,1986, p.55.
Source: Higher Quality IBM 'Clones' Put Pressure on Computer Prices," by Brenton R. Schender, ***The Wall Street Journal***, May 15,1986 and "Calling Long Distance: User Voice Shows Strong Support for AT&T," by Francine Schwadel, ***The Wall Street Journal***, August 22,1986.