Gateways to entry

How the same factors that give rise to market barriers can be exploited to the entrant's advantage

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The entry of new competitors into established markets is a strategic issue for both entrants and existing competitors. The incumbents may be comforted by the thought that their profitable markets are protected by what marketing managers call barriers to entry–whether they be economies of scale, product differentiation, absolute cost advantages, access to distribution channels, superior skills and resources, the threat of retaliation, or any combination of these. On the other hand, potential entrants may worry about the barriers they have to avoid or surmount and whether they can develop strategies that will work to their advantage. However powerful a defense weapon these may be, they are not impregnable. In this article, the author offers a framework for identifying and evaluating the different types of barriers and discusses a new concept for turning them into gateways to entry.

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Managers today, increasingly interested in long-term planning, are achieving corporate growth by selecting new markets to enter and developing the appropriate entry strategies. The other two sources of corporate growth–present markets and acquisitions–are far less attractive today for many companies than a decade ago. Some companies participate in growth markets, but many others languish in stagnant ones. Moreover, as companies have struggled to manage their newly adopted, fully grown, and intractable "children," acquisition has lost much of the luster it used to hold.

Despite its increasing popularity, direct entry is elusive. Newcomers must penetrate that first line of market defense–barriers to entry. Why do some companies succeed and others fail? Entry is one of the supreme tests of competitive ability. No longer is the company proving itself on familiar ground; instead it has to expose its competences in a new area.

Entry is also a trial for incumbent competitors. The efforts of newcomers to establish themselves frequently render the market less profitable for all. Even worse for the incumbents, the new players often possess superior skills, greater resources, and new ways to compete.

The concept of barriers, developed by industrial organization economists, was introduced into the business world decades ago. Some incumbents may take comfort in thinking that they have erected impregnable barriers to protect their profitable markets. Potential entrants may worry about the heights they have to scale. Yet there has been no systematic approach for managers to use in determining the effectiveness of entry barriers–or to devise ways of overcoming or sustaining them.

This article offers such a framework by building on Michael E. Porter's pioneering work in integrating industrial organization economics with business strategy. The "threat of new entrants" is one

of the five forces Porter identified as governing competition in an industry.[1]

On the basis of my two-year study of barriers to entry, which includes collection and analysis of new data, I will provide a framework for evaluating the different types of entry barriers and how they work. At the same time, I will describe the concept of "gateways to entry," which shows that the same factors giving rise to barriers can be exploited to an entrant's advantage. One crucial conclusion, which I shall elaborate on, is that potential entrants are far less deterred by barriers than marketing managers might think.

Types of barriers

What constitutes entry depends on the definition of the particular market. The entries I will concentrate on are limited to products, assets, and activities developed internally for new markets. Likewise, the barriers described are those that apply to direct entry. Another route that many large companies prefer–acquisition–faces a different set of problems that I will discuss later.

The disadvantages that entrants face relative to incumbents arise from the fact of direct entry and are separate from the disadvantages of size or general inferiority in skills and resources. Smaller-company entrants face the usual size, skill, and resource handicaps common to most existing small competitors. Entry against established incumbents creates additional problems.

Barriers are, therefore, an inherent feature of the market and can exact a cost from all entrants crossing them. The six major classes of barriers–economies of scale, product differentiation, absolute cost, access to distribution, capital requirement, and incumbent reaction–are well known and require no elaboration here.

How they work

Barriers protect markets in two ways: they can deter some potential entrants at the outset, and they can prevent or dampen the success of those who do enter. In my study of nearly 800 markets I found that, contrary to traditional economic theory and marketing managers' beliefs, most types of barriers seldom deter entrants. For example, high-barrier markets are no less likely to be entered than those with low barriers. (See the accompanying ruled insert for my study methodology.)

On the other hand, many entrants are not particularly well qualified to achieve success. From my subsample of 31 representative markets, the 45 most successful direct entrants typically had a worse position than the leading incumbents on most of the important strategic dimensions: product quality; price; cost; production, sales force, and distribution effectiveness; advertising and promotion expenditure; and reputation or brand name.

The weak strategic position of the 45 direct entrants resulted in poor performance on the most important measure–market share. Two-thirds of the entrants, even six years after entry, had failed to capture a share level that the incumbents estimated as the minimum required for a major competitor in a particular market. Unfortunately for incumbents, even the weak share performance of the new entrants reduced the existing competitors' profit margins on sales by an average of 7%.

Reducing or avoiding barriers

Barriers often produce disadvantages for both parties. Ignoring barriers, newcomers rush in–with kamikaze results for themselves as well as incumbents. Using a two-step process, direct entrants can evaluate barriers and their chances of success. First, potential entrants should examine the extent of each type of roadblock. (I will not elaborate on this step since it is the easier one; what is difficult is having the discipline to do it, explicitly and thoroughly.) The much harder second step is a determination of whether and how they can reduce or avoid the barriers.

The key to the second step lies in one of two strategic approaches: (1) whether the entrants can reduce barriers by using the same competitive strategy as the incumbents or (2) whether the entrants can avoid them by using a different strategy.

Barriers are obviously most effective when entrants challenge incumbents at their own game with fewer skills and resources. A successful strategy consists, of course, of many elements spanning all business functions: marketing, production, financial, and so forth.

The more mature the market, the more likely it is that customer, channel, and supplier practices and expectations have drastically curtailed any challenger's range of strategic choice. Thus, it is doubly

1 See Michael E. Porter, "How Competitive Forces Shape Strategy," HBR March-April 1979, p. 137.

Study methodology

I studied 793 U.S. and Canadian consumer and industrial product markets drawn from the PIMS (profit impact of market strategy) research base. I observed each market for one five-year period, with the periods ranging from 1972 to 1979. This sample represents at least 60% of all four-digit SIC-defined manufacturing industries in the United States. I designated an entrant a new competitor that had obtained a minimum of 5% market share. My results are from multiple regression, with entry as the dependent variable and the indicators of barriers as the independent variables.

The negative results on the deterrence effect of barriers contradict much previous research by economists. See my book *Barriers to Entry: A Corporate-Strategy Perspective* (Lexington, Mass.: D.C. Heath, 1982). For more information about the PIMS data base, see Sidney Schoeffler, Robert D. Buzzell, and Donald F. Heany, "Impact of Strategic Planning on Profit Performance," HBR March-April 1974, p. 137.

tempting for entrants to use a clone strategy: incumbents have demonstrated how to execute it and customers have shown that they accept it. My evidence cited earlier – that newcomers have worse strategic positions than incumbents – strongly suggests that most entrants do use clone strategies that they execute with less experience and fewer assets.

Using the same strategy

If they deploy sufficient skills and resources, direct entrants using the same strategy as incumbents can minimize barriers. Challengers who already operate in other markets can transfer capabilities to the new market to reduce the effect of the barriers they face. Most entrants already have other markets; of the U.S. entrants in my study, only eight were new companies.

Indeed, even newly created entrants have abundant skills, and perhaps resources, if they are founded by executives breaking away from an incumbent in the same market. Witness the spawning of many such companies in the computer industry. And the airline industry is also demonstrating this phenomenon – as Southwest Airlines has given birth to Muse Air and Texas International Airlines to People Express.

The existing talents and assets of new entrants can reduce barriers in many ways:

☐ Required *economies of scale* may already be met. For example, huge economies are possible in R&D if the entrants develop many products from one set of laboratories. On the other hand, even the incumbents may find the required scale too great for them. Recently, Richardson-Merrell, Inc. divested its ethical drug business mostly because its sales could not support the minimum necessary size in R&D.

☐ The *product differentiation* disadvantage may be offset if the entrant uses a well-known brand name from one of its existing markets. An entrant's name in other fields may even be stronger than existing brands in the entered market. In its incipient all-fronts assault on the total market for financial services, American Express will doubtless benefit from a name recognition and prestige greater than that of almost all incumbents in the markets it attacks.

☐ Entrants may already have access to the labor or raw material sources that give an *absolute cost advantage* to incumbents. They may even have access to cheaper labor or raw materials, an advantage enjoyed by many new competitors from the Far East.

☐ Entrants may already possess *distribution* networks to serve the new market. For example, the preferred diversification strategy of consumer products marketers is to develop new products for distribution through their existing channels. Dart & Kraft recently announced its entry into the wine market, using the Kraft sales force to obtain rapid distribution. Conversely, Komatsu, the Japanese entrant in the U.S. earth-moving equipment market, has been limited to a 10% segment share and a 3% total market share, primarily because the U.S. incumbents had already tied up the best dealers. In particular, market-leading Caterpillar has twice as many (and mostly exclusive) high-capitalized dealers as Komatsu's nonexclusive, low-capitalized dealers.

☐ Existing companies that have no problems in raising the *capital required* for direct entry often enter markets to reinvest surplus funds. IBM and Xerox dominate the market for electronic office equipment, which needs a great deal of capital for basic R&D and product development. A recent entrant, Exxon, has not found capital to be a barrier (as might be expected).

☐ Incumbents may be less eager to *retaliate* against an entry launched by an existing company with a deep pocket or a reputation as a tough competitor. Even better than a rich parent company is a generous government or two. Airbus Industrie was able to enter the U.S. market by offering financing provided by European governments to Eastern Airlines, which Boeing could not match.

If barriers are a wall, existing skills and resources are a platform. Thus, entrants can go beyond reducing the height of barriers and can, in fact, obtain an advantage over incumbents. For example, if the barrier is product differentiation created or maintained by

high advertising expenditures, an entrant more adept at advertising or with more resources to spend on it can turn this barrier against incumbents. Thus, advertising becomes a quick way to get into the market, and the product differentiation issue becomes a gateway to entry.

Procter & Gamble is a master of the higher-platform gateway. Its entry strategies are seldom radically new. Instead, they combine incremental advantages on many dimensions with overwhelming marketing support. P&G took such an approach in its entry into the tampon market with Rely. The results were disastrous for competitors, who were saved only by the toxic shock crisis, which prompted P&G's reluctant retreat.

Advantages of lateness

Often, direct entrants need not even have superior skills and resources to benefit from a higher platform. There can be a number of advantages in lateness:

☐ Entrants can feature the latest technological improvements in their products, while incumbents are committed to their current investments. Prestel in Britain, the world's first commercial system in view-data/videotext, has been surpassed in technological capabilities by a later German entrant. The West German Bundespost built its superior Bildschirmtext system on Prestel software and know-how. A game of leapfrog will no doubt continue in this market.

☐ Entrants can achieve greater economies of scale than incumbents. Usually the optimal size of plant continually increases, with corresponding cost decreases.

☐ Entrants can obtain better terms from suppliers, employees, or customers. In many markets, older companies are locked into higher labor costs. For example, new airlines such as New York Air and People Express enjoy big cost advantages because they employ younger and less expensive crews and also because they are generally less encumbered by contracts, union agreements, and route-system obligations.

☐ Entrants can offer lower prices that incumbents find costly to match. An entrant offering lower prices to part of the market poses an unpleasant dilemma for incumbents: Should they forgo all of the margin on some of their customers by not matching the entrant's cut, or should they forgo some of the margin on all of their customers by matching the cut?

☐ Entrants can attack the particular weak link of a business strategy, while incumbents cannot fully respond without upsetting their entire system. In the tight-knit world of oil field services, SWECO invaded the market for "mud cleaners" – that is, the equipment for cleaning and recycling drilling fluid – and captured a large share of it. SWECO sold only the cleaners while incumbents sold the cleaners and the mud. Whereas the mud had furnished the greater portion of incumbents' revenues, SWECO's more efficient cleaners reduced mud consumption. Thus, the incumbents were constrained in defense of the equipment portions of their drilling-fluid systems.

In markets where lateness offers advantages, incumbents are riding a down elevator relative to future entrants.

Using a different strategy

The higher-platform gateway holds for direct entrants using essentially the same, but stronger, competitive strategies as incumbents. The only qualitative differences are in incremental improvements such as more up-to-date plant and equipment. Even a markedly superior product is a clone strategy when the product provides the same customer benefits as existing products.

Another major gateway involves using a different strategy from incumbents. Such a strategy need not be stronger to create a gateway. And entrants need not be strategic clones of incumbents.[2]

The three sources of different strategies are: (1) radical opportunities to exploit technological or environmental changes, (2) opportunities to avoid direct competition, and (3) opportunities to negate barriers by changing the accepted business structure.

Exploit technological change

Radical technological or environmental changes usually offer the widest gateway for most entrants, and such changes tend to be the most dangerous for incumbents. When incumbents are unwilling or unable to adapt, they magnify the entry opportunities posed by technological change. In cardiac pacemakers, for example, market leader Medtronic invited a breakaway entrant in the early 1970s when it failed to switch to a new lithium-based technology. Medtronic wanted to milk its existing product lines rather than to invest in new ones. The entrant, CPI, had no such constraint, thereby using a product innovation to offset the incumbent's reputation and distribution barriers.

Technological and environmental changes can also easily destroy the scale barrier to entry. The entrenched companies' commitments to

2 The reader might argue that there is always *some* basis for competitive difference. See Theodore Levitt, "Marketing Success Through Differentiation – of Anything," HBR January-February 1980, p. 83.

Antitrust intervention

The theory of entry barriers has made an impact on U.S. antitrust policy, which has as a major goal the maintenance of easy market-entry conditions. The theory has been invoked to support two major types of government intervention.

The first type alters market structures to reduce barriers to entry. The most recent example was the Federal Trade Commission's lengthy investigation of the breakfast cereals market. The FTC argued that a combination of brand proliferation and high market concentration created insurmountable entry barriers. Its proposed remedy was the mandatory licensing of existing trademarks to new competitors. Finally, last January the FTC abandoned its ten-year effort to alter that market structure and dismissed the cereals case.

The second type of intervention encourages direct entry by discouraging acquisition entry – that is, it encourages the introduction of a new competitor but discourages an entrant from buying an existing competitor. This policy is based on three major assumptions underlying the theory of entry barriers:

1
That the presence of potential direct entrants would constrain incumbents from reaping "excess" profits. An acquisition entry by a potential direct entrant would reduce such constraints.

2
That potential entrants would enter directly if denied the acquisition route.

3
That direct entry promotes competition but acquisition entry does not.

In 1979, the Federal Trade Commission forced Exxon to partially operate at arm's length its new acquisition, the Reliance Electric Company. The FTC argued that Exxon could and would have entered the drives industry on its own had it not acquired Reliance.

These two types of antitrust intervention are now seriously questioned by the Reagan administration and by James C. Miller III, chairman of the FTC.

large-scale but obsolete facilities become their feet of clay – both fragile and immobile.

Legal and regulatory changes have frequently removed or lessened the barrier imposed by law. Such changes should not be equated with the creation of gateways. The removal of the legal or regulatory barrier merely allows entry, which can be sufficient for successful follow-through if the legal barrier had restricted satisfaction of demand. Where no great imbalance of supply and demand exists, entrants must still find gateways via superior skills and resources, the advantages of lateness, or some strategy different from that of incumbents.

The recent deregulation of the airline industry provides examples of entry into both situations of unsatisfied demand and supply-demand balance. Some new airlines have simply created new routes between previously unserved destinations: a me-too strategy has been sufficient in such cases. Others, such as New York Air, have entered existing routes but with some areas of advantage over incumbents.

Avoid direct competition

Entrants cannot rely on technological or environmental changes to create gateways, nor can incumbents rely on their absence as surety of protection. Entrants can also sidestep barriers by avoiding direct competition with incumbents – that is, by offering a product or service that satisfies another need or customer group. Obviously, a sufficiently different offering may constitute a separate market. Yet incumbents should be wary. American and British motorcycle manufacturers have learned to their sorrow that what they considered a different but contiguous market – small motorcycles – was to the Japanese a beachhead in the same market.

Such flank-attack entries pose two types of danger for incumbents, as well as corresponding opportunities for entrants. The flank position can be used as a base to gain experience and credibility for invading the core market, or – often more dramatic – the flank position itself becomes the core market. Michelin's push into the United States with steel-belted radial tires greatly accelerated the shift of the core market from bias-ply to radial.

How does a flank entry avoid barriers? A product appealing to a somewhat different need or customer group obviously avoids some of the differentiation barrier. For example, entrants selling liquid soaps are assailing the hitherto monolithic toilet-soap oligopoly. In one year, the number of competitors offering liquid soap for domestic use jumped from 0 to 40.

The liquid-soap example also shows how the flank strategy can reduce scale barriers. To achieve comparable costs, entrants have not needed to build huge plants similar to those of incumbents. Their differentiated entry also reduces the distribution barrier. Obtaining shelf space is much easier than with a me-too product.

Reduction of the scale, differentiation, and cost barriers can obviously lower the capital barrier. Versatec made a successful low-capital entry into the computer peripheral-plotter-machine market by minimizing all facets of the scale of its operation. This approach was sound because Versatec focused on a narrow and untargeted market segment.

Perhaps the most dramatic aspect of avoiding direct competition is its impact on the retaliation barrier. If incumbents keep to their existing prod-

3 See Ralph Biggadike, "The Risky Business of Diversification," HBR May-June 1979, p. 103.

uct lines, an indirect entry avoids the full rigors of direct retaliation, which requires matching the entrant's product. Frequently, however, incumbents are constrained from such direct retaliation. Cannibalization of existing sales intervenes. So does the fear of giving the entrant a stamp of approval. For the past decade, U.S. automobile manufacturers have faced this dilemma concerning smaller imports. Traditional soap companies feel similarly constrained about the new entrants. As yet, only Procter & Gamble has decided to copy them. Facing the same situation in the United Kingdom, neither of the market leaders (Lever Brothers and P&G) has responded.

Negate the barriers

The third flank gateway is to change the accepted business structure and thus avoid the barriers, while still offering competitive products. The soft-drink industry, for example, poses huge distribution barriers since there are a limited number of bottlers, most of whom have highly lucrative contracts with Coca-Cola or Pepsi. Shasta negated this problem by distributing its product in a different way – directly to supermarkets. And Japanese manufacturers of many consumer durables have overcome service network barriers in the United States by building more reliability into their products.

Entrants who choose this approach benefit most in terms of the retaliation barrier. That is, incumbents have built barriers via their existing business structure, and these commitments become their own barriers to response. A radically new business structure can also provide marketing, as well as production and delivery, advantages. Federal Express uses an uncommon production system – delivering packages in its own planes – as its main marketing tool.

All three differentiated strategies – exploiting technological or environmental changes, avoiding direct competition, and negating the barriers – rely on incumbents' responses being restrained by their own commitments. Given the absence of such constraints, however, entrants – even the me-too's – can benefit from the lethargy of those already in the market.

An earlier study by Ralph Biggadike found that entrants faced little direct reaction from incumbents;[3] the fear may be greater than the reality. Large, established parent companies seem the most feared, since their markets are among the least likely to be entered.

The acquisition route

Acquiring a competitor is another gateway to entry that of course avoids the barriers altogether: this strategy does not add a competitor but does introduce a new one. These new owners may have more ambitious plans than the previous owners, and they may also have the resources to back those plans. Such a new competitor may also play the game differently. Thus, acquisition entry may be the prelude to a blitzkrieg on incumbents, without any initial barriers to slow the assault.

Acquisition entry is a frequently exercised option. My subsample of 31 markets reveals that there is one acquisition entry made for every two attempted directly. Acquisition's advantages over direct entry arise to the extent that the acquiring of immediate share, assets, and skills allows the new owners to avoid not only entry barriers but also the uncertainty of high-risk new ventures.

A classic example of the dangers to incumbents of acquisition entry is Philip Morris's acquisition of Miller Brewing Company. Philip Morris entered the beer market with the intention of converting Miller from a minor competitor with a 4% market share into a major one. Ten years later, Miller is now second in the market with more than a 20% share. Philip Morris had both the financial resources and competitive skills to exploit its 4% entry base fully.

Incumbents should therefore be aware of the threat of acquisition entry as a potential Trojan horse – dangerous new competitors may pass right through the front gate. For example, Bausch & Lomb, which had been so successful in the contact lens market that it drove weaker competitors to sell out to large and aggressive acquisition entrants, in recent years has found itself competing with Revlon, Schering-Plough, Johnson & Johnson, Ciba-Geigy, SmithKline, and Nestlé.

Reasons for caution

Despite its advantage in avoiding barriers, for the following reasons entrants should not automatically choose the acquisition mode:

☐ The acquisition route is not always available, since the supply of candidates in a market at any time is usually limited. In addition, antitrust constraints may come into play.

☐ There are differing financial and managerial implications between direct entry and acquisi-

tion. The financial differences in terms of both the balance sheet and the profit-and-loss statement are obvious. Less evident are the differing risks and opportunities faced by the managers responsible. Direct entry is usually the more risky gateway since no guarantee exists that there will ever be an ongoing business of the required size and profitability. The generally long period of start-up losses imposes many strains and career risks on managers.

On the other hand, acquisition entry normally imposes different risks and demands on managers. To justify the price paid, those responsible for operating the new business may be expected to make rapid turnaround improvements or to quickly achieve synergy with the new owner. The two modes may therefore require different styles of management – a more entrepreneurial approach for direct entry and a more organization-conscious and cost-conscious approach for acquisition entry.

☐ Perhaps most important, to the extent that capital markets are efficient, the price of an acquisition includes a premium representing what it would have cost an entrant to breach the barriers directly. An entrant that can reduce or avoid barriers in the ways I have described would therefore be paying too much to achieve entry via acquisition. Thus, acquisition should be a fallback choice for those seeking to enter high-barrier markets without the time, skills, or resources to penetrate those barriers. My study findings confirm that markets with high barriers are more likely to be entered via acquisition than directly.[4]

Some caveats

While the foregoing framework for evaluating the different types of barriers and how they work offers several paths for potential entrants to explore – gateways to entry that involve both reducing and avoiding barriers – some caveats are in order.

In using existing skills and resources to reduce entry problems, these assets must really be transferable to the new market. A realistic assessment of ways of lowering barriers requires a clear specification of how these various capabilities will be applied. A general sense of synergy is not enough. Anheuser-Busch, which has many apparent skills and resources to apply to the soft-drinks business, has failed twice in entry attempts.

In using a differentiated strategy to avoid barriers, entrants have to ensure that they deliver real advantages in cost or customer appeal. Many companies have been lured into setting up operations to deliver a different product that customers supposedly crave. Even economists have fallen into this trap. Encouraged by the grumblings of clients, the field of commercial economic forecasting has recently spawned breakaways. These entrants have found the grumblings to be mostly just that.

Potential entrants face many barriers but they also have a range of options – from a me-too strategy applied with fewer capabilities to combinations of multiple advantages via both resource superiority and strategic differentiation. The strongest entry strategy, however, is not automatically the best choice because it is also usually the most costly, difficult, and time consuming. Entrants need to balance the increased chance of success from stronger strategies against their increased cost of implementation and delay. ⛉

4 See my report, "Diversification Entry: Internal Development versus Acquisition," *Strategic Management Journal,* October-December 1982.

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