The Market Share Effect: New Insights from Canadian Data

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ABSTRACT

This paper examines the relationship between market share and profitability in light of evidence that market share and profitability may not be related directly but any observed relationship may be the result of a spurious correlation. It also tests the hypothesized U-shaped relationship proposed by Porter, and Sheth and Sisodia among others. The results obtained here do not support the positive market share profitability hypothesis. Also, we found no support for the U-shaped relationship. Evidence, however, is found in favor of a positive relationship between profitability and quality of management, especially when the five year average of return on equity is used as an independent variable. The use of the five-year average as an independent variable also eliminates the possibility that environmental conditions may be responsible for the results.

Keywords: Market share; Market share effect; Profitability, PIMS

INTRODUCTION

The relationship between market share and profitability continues to be an important research issue in strategic management. Rumelt and Wensley (1980) argue that the observed association between market share and profitability is an empirical regularity that requires a theoretical explanation. There is a widely held belief that market share and profitability are strongly related (Buzzell and Gale 1987; Simon 2010). Research conducted in the 70s by Gale (1972), Shepherd (1972) and Buzzell, Gale and Sultan (1975) supported the hypothesis of a positive relationship between market share and profitability. Buzzell (2004) notes that the majority of studies on the topic find a linear positive relationship between market share and financial performance.

However, there appears no consensus in terms of the findings. Some of the early studies supported the view that there is lack or a negative relationship between size and profitability. But following the empirical and theoretical studies of Baumol (1959), Stekler (1963), Shepherd (1972), Gale (1972) and Buzzell, Gale and Sultan (1975) in conjunction with the increased popularity of the experience curve, a positive link between market share and profitability became the accepted view among management and marketing theorists. As a result, consultants and strategy experts advised managers that unless their firm can achieve a high market share and/or dominate its chosen market, the firm should withdraw from that market and invest elsewhere.

More recent research claims that the evidence in favor of the market share effect hypothesis is far from being conclusive (e.g. Jacobson and Aaker 1985). Other strategy experts including Porter (1980) and Sheth and Sisodia (2002) advocate a U-shaped relationship between market share and profitability. The inconsistent findings and different explanations suggest that there is a need for more research in this important area. The primary objective of this article is to review the literature in this area and present within an organized framework the issues pertaining to the issue of market share and profitability. It will also empirically investigate the market share profitability relationship using Canadian data. This relationship is tested using a data set that consists of market and financial data compiled from various Canadian sources. The ultimate objective of this article is to help obtain a better understanding of the market share effect. An improved understanding of the central tendency of the market share effect can enhance our understanding of the direction and magnitude of the impact of market share on profitability. Finding the true nature of the relationship would be of interest to strategic management theorists and practitioners due to the importance of such a relationship. This knowledge can help managers improve the performance of their firms by putting their scarce resources to their most productive use.
LITERATURE REVIEW

The first attempts to establish a relationship between market share and profitability, according to Scherer (1980), were made by industrial organization economists. The most comprehensive early attempts were studies conducted by Epstein (1934), Crum (1939), and Alexander (1949): all of these studies found a negative relationship between profitability and size. In a subsequent study, Stekler (1963) found that profit ratios declined with size for profitable firms, but profits increased with size for small and medium firms when all firms were included. Hall and Weiss (1967) found a positive relationship while Mancke (1974) and Whittington (1980) found no relationship between size and profitability.

These first efforts used absolute size whereas most of the later efforts have been using market share or relative market share as the independent variable and as a measure of competitive strength. Among studies that used market share, Gale (1972) found a positive relationship between market share and profitability. This relationship was significantly greater when the industry was highly concentrated or industry growth was medium but no significant effect in cases of rapid industry growth. Shepherd (1972) also found a significant positive relationship between market share and profitability.

In a much discussed study using the PIMS database Buzzell, Gale and Sultan (1975) found a positive link between market share and profitability. This article showed that, regardless of whether market share is defined by rank or percentage, there is a strong correlation between market share and profit margin. The PIMS data set revealed that a company with a market share of 40 percent will achieve a profit margin twice as high as the competitor 10 percent of the market (Simon 2010). Therefore, the strategic implication of these findings is that firms should strive to achieve a higher market share in order to reap the advantages of higher economies of scale and experience. Underlying the concepts of economies and economies of scale is that a company’s cost position depends on its relative market share. The higher the relative market share the lower the company’s unit costs are and the higher the profit margins. The most important question about the relationship is whether it represents a mere correlation or a true causal relationship (Ailawadi, Farris and Parry 1999).

The existence of a positive link between market share and profitability was not found in other studies, however. Whittington (1980) tested the relationship between size and profitability and found no relationship between the two variables. In another study, Schmalensee (1985) found a statistically significant but negligible quantitative market share effect. Mueller (1986) also found a positive link between market hare and profitability using longitudinal data, but this relationship was weakened by the existence of concentration levels.

Jacobson and Aaker (1985) tested for the existence of a market share effect using the PIMS data base. Jacobson and Aaker (1985) found a positive relationship between market share and profitability but this relationship disappeared or became negligible when lagged profit variables were included in the model. According to Jacobson and Aaker (1985), although a direct relationship between market share and profitability may exist, it may be a spurious relationship and an indirect result of other variables such as quality of management which primarily determines profitability. Buzzell (1990) criticized Jacobson’s approach of using one-year and two-year lagged return on investment as inappropriate. Hildebrandt and Buzzell (1991) used a structural equation model to analyze changes in profitability over 6-year periods, a time span more suitable for observing strategic changes in market position. They showed that increases in market share led to improvements in key cost components and in productivity, which in turn led to increases in profitability.

Other studies have also concluded that the market share effect is a modest or nonexistent one (Boulding and Staelin 1990; Jacobson 1990; Szymanski, Bharadwa and Varadarajan 1993; Wensley 1997). Szymanski, Bharadwa and Varadarajan (1993) found that market share has a significant and positive effect on profitability. However, the estimated relationship is moderated by model specification, sample, and measurement factors, suggesting that third factors greatly diminish such a relationship (Szymanski, Bharadwa and Varadarajan 1993). Specifically, they find that the market share effect on profits is diminished and becomes close to zero on average when firm-specific variables are included into the profit model. In their view, incorrect modeling decisions can have an important biasing effect on the estimate of the market share effect. Simon (2010) tested this relationship using absolute and relative market share. He found no significant correlation between the two factors.
Roper (1999) found that above average growth in sales and return on assets are only weakly related in the short term. These growth rates are completely dissipated in the long term. Small firm performance depends strongly on strategy choice, highlighting the importance of choosing the correct strategy. The choice of a particular strategy will depend on the business current and anticipated environment and the capabilities, resources, aspiration, vision, and background and strategic orientation of managers. Short-term increase in growth has no impact on profitability. Growth promotion effects are unlikely to improve profits.

The most common explanation as to why market share leads to higher profitability are higher economies of scale and experience and market power (Buzzell 2004; Jacobson, 1988). Economies of scale provide larger firms with cost advantages (Demsetz 1993; Sharp et al. 2002). However, most studies indicate that economies of scale dissipate at a small percentage of the market. Demsetz (1973) postulated the efficiency hypothesis as a possible explanation of the market share effect. According to the efficiency hypothesis, market share is the consequence of efficiency rather than its cause. Differences in profitability among firms are due to higher efficiency. Efficient firms obtain large market share and earn high profits induce a causal association between size and profitability. Firms offering products that offer customers greater value enjoy gains in market share. Better managed firms that have a competitive advantage grow faster than rival firms. Firms with superior skill and foresight gain market share through lower prices or through better products. Caves and Porter (1977) and Woo and Cooper (1981,1982) provide evidence that smaller-share competitors are equally or even more profitable than larger rivals.

Some researchers have advanced arguments in favor of a U-shaped relationship between market share and profitability (Amburgey, Dacin, and Kelly 1994; Boon, Carroll and van Witteloostuijn 2004; Dobver and Caroll 2003; Porter 1980; Sheth and Sisodia 2002). Porter’s (1980) rationale is that only small and large firms earn high profits because they can reap the benefits of either product differentiation which is associated with small size or cost advantage that is associated with large size respectively. Sheth and Sisodia (2002) theorized that there is an optimal industry structure consisting of three large generalists and numerous small specialists occupying various niches in the industry. Sheth and Sisodia (2002) argue that industries evolve toward a dynamic equilibrium in which existing and new firms are consolidated. In the absence of anticompetitive practices, or regulatory constraints, any given industry is expected to evolve toward an optimal structure in which there are three full line generalists and numerous small specialists that occupy small niches. This line of thinking parallels research that shows that the vast majority of industries are highly skewed in a way that there are a few large firms that dominate their industry while numerous small firms occupy small niches (Axtell, 2006; Yannopoulos 1984). Medium size firms, on the other hand, are at a disadvantage and are less profitable because they are stuck in the middle and they do not achieve any competitive advantages. Can, Ayca and Winsor (2010) found evidence that supports the U-shaped hypothesis. These results suggest that the relationship between market share and profitability may be non-monotonic.

Methodological Issues

One of the major weaknesses of the studies on the relationship between market share and profitability is that they have relied primarily on evidence based on large firms, giving rise to a serious sampling error (Szymanski, Bharadwa and Varadarajan 1993). These data come from the largest U.S. and U.K. firms or firms whose market shares are traded in the stock market. Also, most of the evidence for the existence of the positive relationship between market share and profitability comes from the PIMS database (Faris and Moore 2004). The PIMS data base also includes mostly large business units or large diversified companies, while there is very little input from smaller companies. It is also known that the subjective nature of the PIMS database presents further problems and limits the validity of the results. A meta-analysis of these studies shows that its use has inflated estimates of the market share effect-profitability relationship (Szymanski, Bharadwa and Varadarajan 1993). In their meta-analysis they used a large number of empirical studies about the market-share profitability relationship. They found that the PIMS sample of businesses is biased relative to the overall population of businesses, bringing into question PIMS-based findings. These limitations severely weaken the ability to generalize the PIMS results given that the sample is not representative of the total population of firms since the results are biased in ways that could affect the magnitude of the results (Anderson and Paine 1978). For this reason, Jacobson and Aaker (1985) suggested that researchers should use alternative to PIMS data bases.
Another weakness of the data used is that they are drawn from a given period of time and as such, some of them may be historical accidents. A case in point is the study done by Mueller (1986) who found that market share and profitability are positively related, and that profits tend to persist either above or below average. Yet, as Mueller conceded, the data on which this study rests are for the non-turbulent fifties and sixties, ending with 1972, the year before OPEC first sent economic shock waves through Western developed countries. It was before General Motors, Ford and International Harvester, after years of continuous profits began to experience losses.

The view that market share and profitability are positively related has been challenged by a number of theorists at both the empirical and theoretical level over the years. Abernathy and Hayes (1979) pointed out some of the limitations of using the experience curve as a strategic tool. Porter (1980) put forth arguments in favor of a U-shaped profit market share relationship. Similarly, Hambrick and MacMillan (1982) suggested that market share is more important for very small and very large firms. Woo and Cooper (1982) found that some low market share firms were successful and, thus, high profitability is not limited to large firms only. Jacobson and Aaker (1985) who tested this hypothesis found evidence that market share is important for very small firms but not for very large firms, suggesting that economies of scale might be an impediment to higher profitability for small firms. This finding is consistent with the argument that economies of scale exist but the relevant range applies only to very low market share businesses (Scherer 1980).

**Theoretical Issues**

Due to its importance for public policy and business strategy, the relationship between market share and profitability has been extensively discussed and researched by industrial organization economists and strategic management academics and practitioners. This research involves both empirical and theoretical arguments. Among the major theoretical arguments are included economies and diseconomies of scale, experience curve and other cost advantages, market power, innovation, quality of management, and random effects (Porter 1980; Baumol 1959; Nelson and Winter 1982; Buzell, et al. 1975).

**Cost Advantages** The rationale most commonly offered to explain the market share effect is that higher market share enables firms to utilize economies of scale and experience. This in turn helps reduce costs and gives firms market power that they use to extract favorable concessions from suppliers, channel members, and customers (Buzell, Gale and Sultan, 1975). Buyers use market share as a signal of brand quality and a brand’s acceptance as an indicator of superior quality (Smallwood and Conlick 1979). The available evidence supports that economies of scale exist up to a certain minimum efficient size (MES). Beyond this point, the long run average cost curve flattens out (Bain, 1956, Scherer 1980). It has been estimated that the MES is consistent with a low market share (Bain 1956; Scherer 1980; Szymanski, Bharadwa and Varadarajan 1993) indicating that economies of scale dissipate at a small percent of market share (Scherer 1974; Rummelt 1995). Therefore, even businesses with relatively small market shares can be operating at levels greater than the minimum efficient scale (Schmalensee 1985).

Other research suggests that high market share may hurt profitability (Schwalbach, 1991) because of the existence of various diseconomies of scale, such as diseconomies of confusion, etc. (Hayes and Wheelwright 1984). The existence of economies and diseconomies of scale imply that small firms suffer from lack of economies of scale and large firms enjoy significant cost advantages due to economies of scale. At the same time, if the size of a firm gets too large, the firm may start suffering from diseconomies of scale which will tend to negate the benefits of large size. Market share may not only contribute to profitability beyond a certain size but it may be detrimental as well. Firms with market shares larger than 40% lose their advantages from scale and scope and experience diminished performance (Geroski 1987; Sheth and Sisodia 2002). The PIMS-based research does not reveal whether profitability will eventually decrease at very high market-share levels in light of evidence of diseconomies of scale.

Experience economies, on the other hand, result from cumulative experience and the associated cost reductions as a result of accumulating production and learning. The existence of experience curves has been documented in numerous studies (Yanopoulos 2007). But it also has become apparent that higher cumulative volume does not automatically lead to lower cost but there must be a conscious effort to take advantage of the potential for cost reductions (Yanopoulos 2007).
Market Power  Large firms have a number of other advantages which are not available to small firms. Greater bargaining power is one advantage that is available only to large firms. Greater size also increases the number of investment options due to larger financial resources. Nelson and Winter (1982) argue that larger firms spend proportionately more on research and development than smaller firms, increasing thereby their chances to innovate and grow faster than their smaller rivals. Gale (1972) also argued that large firms have a share-based differentiation advantage. Furthermore, only large firms have the ability to participate in a tightly kit oligopolistic group and reap the benefits of high concentration (Gale 1972). However, studies show that higher concentration has, either, a neutral or negative impact on the profitability of higher market share firms (Gale and Branch 1982; Mueller 1986). Gale and Branch (1982) note that the market share has little to do with market power but it reduces costs. Similarly, Szymanski, Bharadwa and Varadarajan (1993) found no support for the market power theory.

Quality of Management  Quality of management has received attention as a major cause of higher profitability for some firms (Buzzell, Gale and Sultan 1975; Jacobson and Aaker 1985). Some researchers suggest that the observed positive relationships between market share and profitability may be the result of a common third factor (Rumelt and Wensley 1980; Jacobson and Aaker 1985). This common third factor could be quality of management, luck, or random factors. Superior management causes firms to operate at a higher level of effectiveness and efficiency than their competitors. Higher effectiveness and efficiency include the capability to design and execute better strategies and plans, better control of costs, maintain efficient operations, having innovative products and market strategies, meeting customer needs better than competitors as well as the ability to achieve higher productivity through training and motivation of employees. Some studies have tried to capture these effects by using either instrumental variables (Rumelt and Wensley 1980) or lagged profitability variables (Jacobson and Aaker 1985). Jacobson and Aaker (1985) and Szymanski, Bharadwa and Varadarajan (1993) found support for the impact of product quality.

Economic environment  Mueller (1986) in an extensive longitudinal study found a positive relationship between market share and profitability. Mueller qualified his findings by accepting that the positive relationship he found between market share and profitability may be a direct result of the stability in the economics and competitive environment that prevailed during the sixties and the seventies during which he collected his data. He called for the need to study the moderating effects of the environment.

Random Factors  Mancke (1974) has put forward the hypothesis that higher profitability by some firms may be the reflection of ex post performance in light of successful ex ante uncertain investments. Although Mancke’s hypothesis was criticized by certain industrial organization economists (Caves, Gale,?? and Porter 1977), one would be inclined to agree that stochastic factors are important and must account for some of the profitability differences observed, given that risk and uncertainty are important elements in most business decisions. Philips (1971) has documented a number of cases where some firms were able to become more profitable through successful innovation and grow faster than other firms. Ijiri and Simon (1977) and Yannopoulos (1984) have found evidence of stochastic growth factors in a larger number of industries.

METHODOLOGY

The Data

The data used in the present study is a proprietary one consisting of a cross-section of 600 Canadian firms of various sizes from different industries. This data set was developed by collecting data from a number of different Canadian industry, financial, and government sources and publications. The database includes annual and 5-year averages of financial data: revenue, return on assets, return on equity, relative market share and growth data of these variables. Although 600 firms were initially included in the data set, approximately 300 were included in the final data set given that financial results for the last five years were needed and these were not available for all firms.

The present data set overcomes one of the most often heard criticisms regarding data representativeness. The data set includes information about firms of all sizes, small, medium, large and from a wide spectrum of industries; unlike other data bases where firms were selected either on the basis of their size or whether their shares were trading in the stock market. In addition to including firms of all sizes, the present data set consists of financial and operating results
achieved in an economy which has going through a severe economic recession, with massive layoffs and high unemployment. Many companies went through their worst slump in years and were going through a re-organization process with several cost cutting measures and product market rationalization.

The Model

The first relationship of interest is between market share and profitability. Following previous studies (e.g. Buzzell, Gale and Sultan, 1975), relative market share and return on equity measures were used. Three different models were estimated. The first model included all firms in the sample. The purpose of the first model is to test the relationship between market share and profitability. The second and third models included small and medium size firms and medium and large size firms respectively, to test Porter’s (1980) hypothesis that there is a U-shaped relationship between market share and profitability. If Porter’s hypothesis is true we should observe a negative coefficient in the case of small and medium size firms and a positive relationship in the case of large and medium firms. The model was specified as follows:

$$\text{ROE} = a + b \text{MS} + e$$  \hspace{1cm} (1)

Where: ROE is return on equity, MS is relative market share, a and b are parameters to be estimated, e is the stochastic error term

Equation 1 was fitted on a sample size of 600 firms. The parameters were estimated by means of ordinary least squares. Table 1 provides the results of fitting the model presented in equation 1. The intercept is statistically significant for all three models. But there is no statistically significant relationship between market share and profitability for all three models. Therefore, the hypothesis about a positive market share and profitability link is rejected. Similarly, the results provide no support to the U-shaped relationship.

<table>
<thead>
<tr>
<th>Coefficient Estimates</th>
<th>All firms</th>
<th>Large and medium firms</th>
<th>Small and medium firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>8.58$^a$</td>
<td>10.08$^a$</td>
<td>7.67$^a$</td>
</tr>
<tr>
<td></td>
<td>(1.66)</td>
<td>(2.88)</td>
<td>(2.08)</td>
</tr>
<tr>
<td>Market share</td>
<td>0.04</td>
<td>0.02</td>
<td>0.10</td>
</tr>
<tr>
<td></td>
<td>(0.03)</td>
<td>(0.04)</td>
<td>(0.08)</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.002</td>
<td>.000</td>
<td>.003</td>
</tr>
</tbody>
</table>

Table 1: Regression Results Between Market Share and Return on Equity

a indicates results are significant at 99 percent level
b indicates results are significant at 95 percent level
Standard errors are in parentheses

The next relationship tested was between return on equity as the dependent variable while relative market share and one-year and two year lagged values for return on equity were used as the independent variables. The rationale for including lagged values of variables has been given by Jacobson and Aaker (1985). They argued that since there are omitted variables in the relationship given in equation 1, one way of capturing the effect of these variables and especially the effect of management quality as reflected in customer loyalty, advertising effectiveness, innovation, luck, etc. is by including past values of return on equity. This model includes the lagged variable ROE for the two previous years and is presented in equation 2:

$$\text{ROE} = a + b \text{MS} + c \text{ROE (LAG1)} + d \text{ROE (LAG2)} + e$$  \hspace{1cm} (2)

Where: ROE is return on equity, MS is relative market share, ROE (LAG1) and ROE (LAG2) are return on equity lagged by one and two years, b, c, d are parameters to be estimated, e is the stochastic error term

The results of the equation 2 are presented in Table 2. As it can be seen, much like the first model, market share has low coefficients and insignificant t-values in all three models. In terms of lagged values of return on investment, most, but not all of the lagged variables used produced significant relationships especially ROE lagged one year for large and medium firms. This finding provides support to the hypothesis proposed by Jacobson and Aaker (1985) and others that quality of management is a significant factor that drives the relationship between market share and profitability.
Table 2: Regression Results Between Return on Equity, Market Share and Lagged Return on Equity

<table>
<thead>
<tr>
<th>Coefficient Estimates</th>
<th>All firms</th>
<th>Large and medium firms</th>
<th>Small and medium firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>6.80a</td>
<td>3.86a</td>
<td>6.51a</td>
</tr>
<tr>
<td></td>
<td>(1.49)</td>
<td>(2.38)</td>
<td>(1.83)</td>
</tr>
<tr>
<td>Market share</td>
<td>0.02</td>
<td>-0.01</td>
<td>0.07</td>
</tr>
<tr>
<td></td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>ROE lagged (1 year)</td>
<td>0.15b</td>
<td>0.67a</td>
<td>0.11</td>
</tr>
<tr>
<td></td>
<td>(0.06)</td>
<td>(0.12)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>ROE lagged (2 years)</td>
<td>0.16a</td>
<td>0.04</td>
<td>0.16a</td>
</tr>
<tr>
<td></td>
<td>(0.06)</td>
<td>(0.08)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.07</td>
<td>0.41</td>
<td>0.04</td>
</tr>
</tbody>
</table>

a indicates results are significant at 99 percent level  
b indicates results are significant at 95 percent level  
Standard errors are in parentheses

Given that economies and firms are subject to fluctuations in financial and operating performance due to various reasons including environmental factors, annual data or even one and two year lagged values may be unsatisfactory for the purpose of capturing these effects. As a alternative way of capturing the omitted variable effects of the environmental uncertainty and other exogenous effects we use the average return on equity for a five-year period. Such a construct has the advantage of smoothing out any year to year fluctuations and at the same time it captures the effect of the previous years’ performance on the current performance. The model presented in equation 3 uses ROE as a dependent variable while market share and the five-year average return on performance are included as dependent variables.

$$ROE = a + b \text{ MS} + c \text{ ROE (AVERAGE)} + e \ (3)$$

Where: ROE is return on equity MS is relative market share ROE (AVERAGE) is the five year return on equity A, b, c are parameters to be estimated e is the stochastic error term

Table 3 shows the results of fitting equation 3 for the three models. The market share coefficient is very low and has insignificant values again as in the previous models. The five-year return on investment is significant and has a relatively high value, indicating that a strong relationship between average return on equity and current profitability exists across all groups. This result, by taking into account the moderating effects of the environment, provides further support to the argument that, it is mainly efficiencies, strategy and quality of management that has a significant impact on profitability. This lends support to Demsetz (1973) efficiency hypothesis and to the arguments of Jacobson and Aaker (1985) about the importance of quality of management in the financial performance of firms.

Table 3: Regression Results Between Return on Equity, Market Share and Five-Year Average Return on Equity

<table>
<thead>
<tr>
<th>Coefficient Estimates</th>
<th>All firms</th>
<th>Large and medium firms</th>
<th>Small and medium firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>3.44b</td>
<td>1.82</td>
<td>3.08</td>
</tr>
<tr>
<td></td>
<td>(1.48)</td>
<td>(2.50)</td>
<td>(1.83)</td>
</tr>
<tr>
<td>Market share</td>
<td>0.02</td>
<td>0.03</td>
<td>0.04</td>
</tr>
<tr>
<td></td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>Average ROE</td>
<td>0.68a</td>
<td>0.67a</td>
<td>0.69a</td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.08)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.30</td>
<td>0.38</td>
<td>0.30</td>
</tr>
</tbody>
</table>

a indicates results are significant at 99 percent level  
b indicates results are significant at 95 percent level  
Standard errors are in parentheses

CONCLUSIONS AND IMPLICATIONS

For decades, managers have learned from professors, consultants, and superiors that high market share is associated with high profitability. According to economies of scale and experience theory, a firm’s cost position depends on its market share. The larger the market share, the lower the business unit’s when compared to the
competition and the higher the profitability. The Boston Consulting Group, using relative market share as a measure of business strength, also contributed to such beliefs.

The results obtained in this paper do not support the market share profitability hypothesis. Porter’s hypothesis of a U-shaped relationship between market share and profitability has not been supported either. Most lagged return on equity values provided significant but of little explanatory power except of one case. Better results were obtained when average profitability values were used. The magnitude of regression coefficients was both higher and statistically significant as well as the explanatory power of the model improved. These results add to the increasing chorus of voices which challenge the prevailing view that market share and profitability are related. The proposed market share effect was not present in the sample of Canadian firms examined in the present study.

The implication of the present study is that the value of market share as a contributing factor towards higher profitability may have been exaggerated in the past, especially, during periods of uncertain and changing environment. The present study has also provided support to the argument that quality of management as well as other firm and non-firm specific factors may be important. In view of this result, management should be spending its scarce resources towards improving the effectiveness of its practices instead of attempting to raise market share at all costs, hoping to improve their profitability from the higher market share. Performance depends not so much on market share but on market or industry conditions, the beginning competitive position of a business unit, and the strategies adopted by the business’ managers during the period (Buzell, Robert. (2004), The PIMS Program of strategy research: A Retrospective approach,” Journal of business Research, vol. 57, no. 5, 478-483.)

Simon (2010) argues that there is a good and bad relationship between market share and profitability. According to Simon, good market shares are earned by superior performance, innovation, quality, and excellent service among others. Market leadership is not attained by price reductions that destroy margins but by maintaining or even increasing margins from providing superior value to customers. On the other side, bad market shares are achieved through price reductions and aggressive promotions to drive up volume without, at the same time, an aggressive effort to cut costs. Such efforts may succeed in the short term but are not sustainable in the long term. They lead to low profits and frequent losses because the costs are too high when compared with the prices offered or prices are too low compared with costs. Thus, what matters is not the price level but, the relation of the price level to the costs that defines the quality of market share. For example, companies such as Costco, Wal-Mart and Southwest have high market shares, are charging low prices, and still earn excellent profits. On the contrary, companies such as General Motors, Ford and other companies are less profitable in spite of high market shares. These companies, in spite of high market shares, have high costs and by engaging in aggressive price wars they end up with insufficient margins because of the high costs of operations. Successful companies gain market shares with superior performance, not with low or aggressive prices or promotions. They grow in sales by being the best in technology, service, innovation, quality, and by lowering costs. High quality organizations may earn a 10%-15% price premium (Simon, Bilstein and Luby 2006). When companies make market share the central focus of the organization, it gives rise to behavior and cultures that destroy profit rather than boost it (Simon et al. 2006).

As discussed earlier, Mueller (1986) found a positive relationship between market share and profitability but he qualified his results by noting that the positive market share effect on profitability might be an artifact of the prevailing stability in the economics and competitive environment during the sixties and the seventies during which he collected his data. The competitive and environmental conditions prevailing at the time of the study are the reverse of those that prevailed in Mueller’s study. During the time period in which the present data were collected the Canadian economy was in a state of recession, with changing competitive conditions, rising imports and many traditionally profitable firms becoming insolvent or operating with losses. Consequently, the result of no relationship between market share and profitability we found in this study may be a direct result of the unstable conditions that prevailed in the early eighties. Thus, the results obtained in this study provide some evidence that during periods of unstable competitive and environmental conditions higher market share and profitability may not be related necessarily.

As a result of the discussion in the previous paragraph, an important variable that might be of interest in future studies – but which was not accounted for in the present study – is the state of the general economic environment at the time the data are collected. Specifically, the data used in this study were collected during a period of time in which the
Canadian and world economy were coming out of one of the worst recessions in years they were in a state of flux, with changing competitive conditions rising imports while many traditionally profitable firms becoming insolvent or being unprofitable. Thus, as we noted earlier, the present results might be indicative of the hypothesis that when unstable competitive and environmental conditions prevail, higher market shares do not necessarily lead to higher profitability or to a U-shaped relationship. Future studies of the market share effect should look at the moderating role of the economic and competitive environment. The present study has provided only indirect evidence of such an effect.

REFERENCES


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