

# The vanishing middle market

Trond Riiber Knudsen,  
Andreas Randel,  
and Jørgen Rugholm



Serge Bloch

*Changing customer needs are prompting a range of strategic responses.*

**Executives recognize** that premium and no-frills offerings are squeezing middle-of-the-road products and services in many industries. Our study of 25 industries and product categories in Europe, North America, and on the global level shows the extent of this phenomenon, known as market polarization.<sup>1</sup> We found that, from 1999 to 2004, the growth rate of revenues for midtier products and services trailed the market average by nearly 6 percent a year (Exhibit 1).

For companies competing in industries and product categories as diverse as appliances, banking, mobile phones, and apparel, growth is strong at *both* ends of the market (Exhibit 2, group 1). Such companies face a difficult choice: either focus on one of the market's extremes and concede ground elsewhere or learn to serve both premium and value customers. Nokia, for example, has opted for the latter approach by attempting to expand beyond its traditional stronghold in the middle market. The company is marketing handsets that boast features such as cameras and MP3 players to customers in the premium segment while offering stripped-down phone models to rapidly growing emerging markets.

A second group of industries and product categories (such as airlines, groceries, and PCs and servers) is seeing growth as customers migrate primarily toward the value-oriented part of the market (Exhibit 2, group 2). For companies in this group, driving down costs is critical because no-frills

competitors are constantly on the lookout for new opportunities—as Dell and Wal-Mart Stores demonstrated several years ago with their expansion into servers and groceries, respectively.<sup>2</sup> Incumbents that can't lower their costs enough may find they have no alternative but to exit the market.

A third group of industries and product categories, ranging from digital cameras and MP3 players to coffeemakers, diapers, and razors (Exhibit 2, group 3), is achieving growth at the higher end of the market. (A similar move toward closer partnerships and value-added solutions is also taking place in many business-to-business industries.) Companies that thrive on higher-end offerings tend to justify higher prices by focusing on innovation that adds value and on forging an emotional connection with consumers or solutions-oriented corporate customers. Consider how Apple's iPod changed the MP3 game or how Gillette has continually broken new ground with its Atra, Sensor, and Mach3 razors.<sup>3</sup>

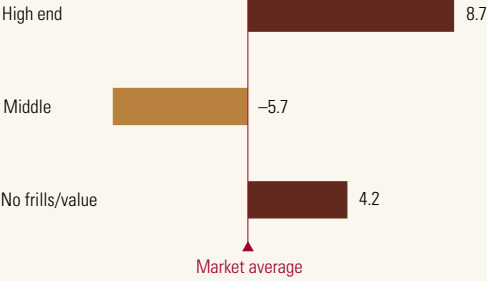
Our research unearthed significant variations in the ways polarization plays out within industries. Consider the refrigerator category in Europe. Although traditional producers and channels have seen their market share for midrange products remain fairly constant, this segment is in relative decline. The explanation is that imports (particularly of new brands at the market's high and low ends),

EXHIBIT 1

**Disappearing act**

Nominal growth of products and services in tier relative to market average for those products and services, 1999–2004, CAGR,<sup>1</sup> %

**Tiers**



<sup>1</sup> 25 industries or product categories—10 in Europe, 9 in North America, and 6 at global level; growth rate for each tier represents weighted average of industries and product categories studied; CAGR = compound annual growth rate.

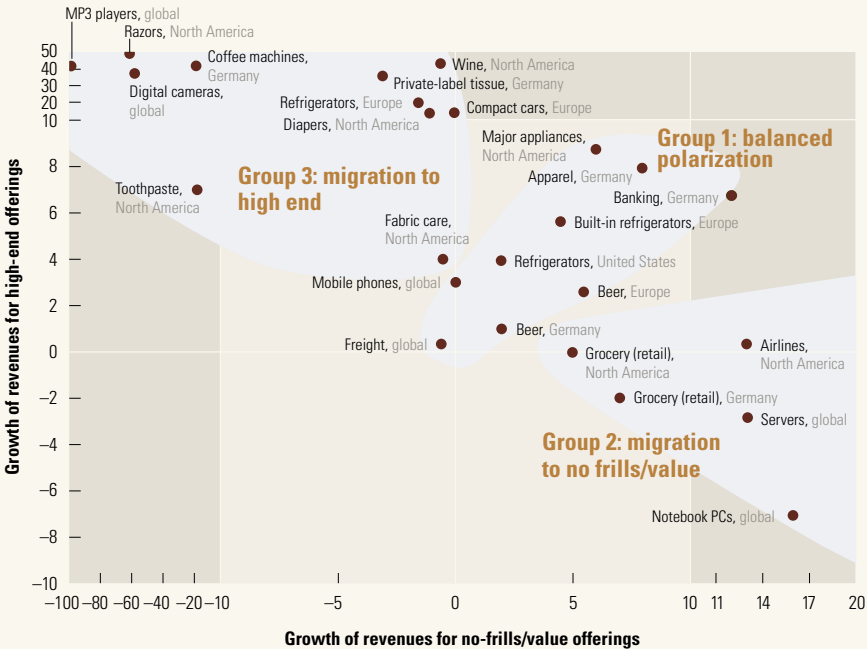
which are often sold through new channels such as hypermarkets and big-box retailers, have grown significantly. The overall market, as measured by the number of units sold, is becoming polarized as much of the revenue growth takes place at the high end (Exhibit 3).

We also found that polarization occurs at significantly different speeds in different parts of the world. The spike in demand for high-end refrigerators happened roughly a decade earlier in North America than in Europe, for example. This phenomenon was perhaps caused by the rapid growth of the top income categories in the United States and by the fact that premium brands such as Sub-Zero and Viking were better established there. Today, however, the growth rates of high-end models in Europe have overtaken those in North America. As companies and

EXHIBIT 2

**Polarization varies across industries**

Nominal growth of revenues relative to market average in given industry or product category, CAGR (log scale), 1999–2004,<sup>1</sup> %

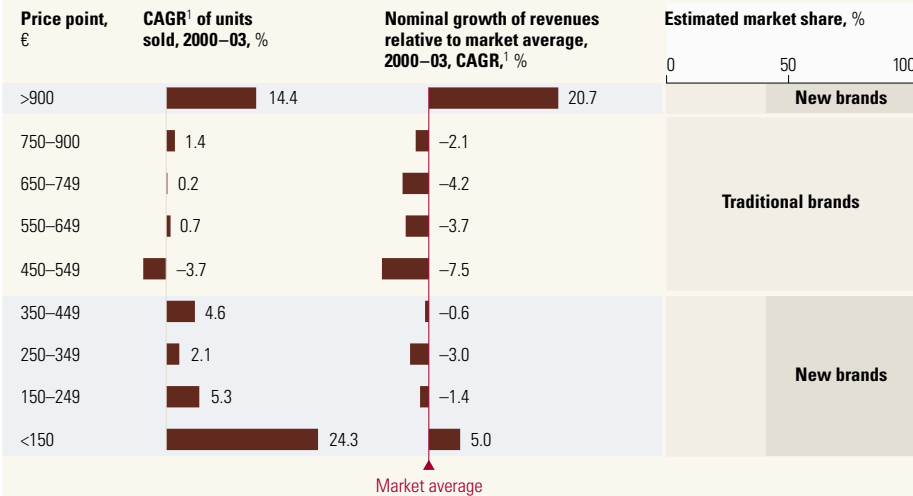


<sup>1</sup> 25 industries or product categories—10 in Europe, 9 in North America, and 6 at global level; growth rate for each tier represents weighted average of industries and product categories studied; CAGR = compound annual growth rate.

EXHIBIT 3

**An example of growing polarization**

European refrigerator industry



<sup>1</sup>Compound annual growth rate.

consumers on the Continent adjust to an expanded European Union, polarization could play out in many different ways.

We also examined a significant example of polarization in Europe’s auto industry. As elsewhere, the compact-car segment traditionally has been associated with midtier brands. Now, however, automakers such as Audi, BMW, and Mercedes are introducing luxury compact models—and changing the segment’s dynamics in the process.

Market polarization is a powerful trend that will continue to have a pronounced impact within channels and across industries and regions. The pattern of polarization does not lie in a category’s DNA, however. Instead, product and service providers and their channel partners will heavily influence how this phenomenon unfolds. For companies hoping to stretch their offerings to take advantage of these

new opportunities, developing a keener understanding of the changing needs of the customer is the place to start.

**Trond Riiber Knudsen** is a director in McKinsey’s Oslo office, **Andreas Randel** is an associate principal in the Stockholm office, and **Jørgen Rugholm** is a principal in the Copenhagen office. Copyright © 2005 McKinsey & Company. All rights reserved.

<sup>1</sup>We examined publicly available and private financial information for corporations from 1999 to 2004. Data came from a selection of 25 industries and product categories: 10 in Europe, 9 in North America, and 6 at the global level.

<sup>2</sup>For more on the impact of value-oriented players, see Robert J. Frank, Jeffrey P. George, and Laxman Narasimhan, “When your competitor delivers more for less,” *The McKinsey Quarterly*, 2004 Number 1, pp. 48–59 ([www.mckinseyquarterly.com/links/19331](http://www.mckinseyquarterly.com/links/19331)).

<sup>3</sup>The company recently announced that a new razor, dubbed the Fusion, will go on sale in early 2006.