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# 3

# Industry Analysis: The Fundamentals

When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.

-Warren Buffett, Chairman, Berkshire Hathaway

The reinsurance business has the defect of being too attractive-looking to new entrants for its own good and will therefore always tend to be the opposite of, say, the old business of gathering and rendering dead horses that always tended to contain few and prosperous participants.

—Charles T. Munger, Chairman, Wesco Financial Corp.

#### OUTLINE

- INTRODUCTION AND OBJECTIVES
- From Environmental Analysis to Industry Analysis
- THE DETERMINANTS OF INDUSTRY PROFIT: DEMAND AND COMPETITION
- Analyzing Industry Attractiveness

Porter's Five Forces of Competition Framework Competition from Substitutes

Threat of Entry

Rivalry Between Established Competitors

Bargaining Power of Buyers

Bargaining Power of Suppliers

■ APPLYING INDUSTRY ANALYSIS

Describing Industry Structure

Forecasting Industry Profitability Strategies to Alter Industry Structure

- Defining Industries: Where to Draw the Boundaries Industries and Markets
   Defining Markets: Substitution in Demand and Supply
- From Industry Attractiveness to Competitive Advantage: Identifying Key Success Factors
- SUMMARY
- Notes

#### INTRODUCTION AND OBJECTIVES

In this chapter and the next we explore the external environment of the firm. In Chapter 1 we observed that profound understanding of the competitive environment is a critical ingredient of a successful strategy. We further noted that business strategy is essentially a quest for profit. The primary task for this chapter is to identify the sources of profit in the external environment. The firm's proximate environment is its industry environment; hence the focus of our environmental analysis will be industry analysis.

Industry analysis is relevant both to corporate-level and business-level strategy.

- Corporate strategy is concerned with deciding which industries the firm should be engaged in and how it should allocate its resources among them. Such decisions require assessment of the attractiveness of different industries in terms of their profit potential. The main objective of this chapter is to understand how the competitive structure of an industry determines its profitability.
- Business strategy is concerned with establishing competitive advantage. By analyzing customer needs and preferences and the ways in which firms compete to serve customers we identify the general sources of competitive advantage in an industry – what we call key success factors.

By the time you have completed this chapter you will be able to:

- Identify the main structural features of an industry that influence competition and profitability.
- Use industry analysis to explain why in some industries competition is more intense and profitability lower than in other industries.
- Use evidence on structural trends within industries to forecast changes in competition and profitability in the future.
- Develop strategies to influence industry structure in order to improve industry profitability.
- Analyze competition and customer requirements in order to identify opportunities for competitive advantage within an industry (key success factors).

## From Environmental Analysis to Industry Analysis

The business environment of the firm consists of all the external influences that affect its decisions and performance. Given the vast number and range of external influences, how can managers hope to monitor, let alone analyze, environmental conditions? The starting point is some kind of system or framework for organizing information. For example, environmental influences can be classified by *source* (e.g. into political, economic, social, and technological factors ("PEST analysis")) or by *proximity* (the "micro-environment" or "task environment" can be distinguished from the wider influences that form the "macro-environment").¹ Though systematic, continuous scanning of the whole range of external influences might seem desirable, such extensive environmental analysis is unlikely to be cost effective and creates information overload.

The prerequisite for effective environmental analysis is to distinguish the vital from the merely important. To do this, let's return to first principles. For the firm to make profit it must create value for customers. Hence, it must understand its customers. Second, in creating value, the firm acquires goods and services from suppliers. Hence, it must understand its suppliers and how to form business relationships with them. Third, the ability to generate profitability from value-creating activity depends on the intensity of competition among firms that vie for the same value-creating opportunities. Hence, the firm must understand competition. Thus, the core of the firm's business environment is formed by its relationships with three sets of players: customers, suppliers, and competitors. This is its industry environment.

This is not to say that macro-level factors such as general economic trends, changes in demographic structure, or social and political trends are unimportant to strategy analysis. These factors may be critical determinants of the threats and opportunities a company will face in the future. The key issue is how these more general environmental factors affect the firm's industry environment (Figure 3.1). Consider the threat of global warming. For most companies this is not an important strategic issue (at least, not for the next few hundred years). For the producers of automobiles, however, the implications of global warming for taxes on gasoline and restrictions on

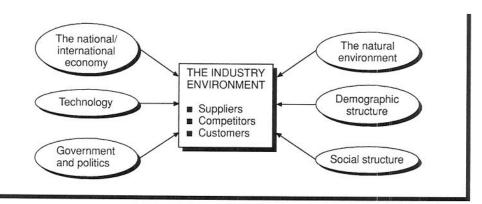


FIGURE 3.1 From environmental analysis to industry analysis

burning fossil fuels mean that global warming is a vital issue. However, to analyze the strategic implications of global warming, the automobile manufacturers need to trace its implications for their industry environment:

- What will be the impact on demand? Will consumers favor more fuel-efficient cars, or will there be a shift from gasoline-powered to electrically powered vehicles?
- Will there be substitution of public transportation for private transportation?
- Will there be new entry by manufacturers of electric vehicles into the car industry?
- Will the heavy R&D costs associated with adapting cars to the new environmental challenge cause the industry to consolidate?

# THE DETERMINANTS OF INDUSTRY PROFIT: DEMAND AND COMPETITION

If the purpose of strategy is to help a company to survive and make money, the starting point for industry analysis is a simple question: What determines the level of profit in an industry?

As already noted, business is about the creation of value for the customer either by production (transforming inputs into outputs) or commerce (arbitrage). Value is created when the price the customer is willing to pay for a product exceeds the costs incurred by the firm. But value creation does not translate directly into profit. The surplus of value over cost is distributed between customers and producers by the forces of competition. The stronger is competition among producers, the more of the surplus is received by customers in *consumer surplus* (the difference between the price they actually pay and the maximum price they would have been willing to pay) and the less is the surplus received by producers (as *producer surplus* or *economic rent*). A single supplier of bottled water at an all-night rave can charge a price that fully exploits the dancers' thirst. If there are many suppliers of bottled water, then, in the absence of collusion, competition causes the price of bottled water to fall toward the cost of supplying it.

The surplus earned by producers over and above the minimum costs of production is not entirely captured in profits. Where an industry has powerful suppliers – monopolistic suppliers of components or employees united by a strong labor union – a substantial part of the surplus may be appropriated by these suppliers (the profits of suppliers or premium wages of union members).

The profits earned by the firms in an industry are thus determined by three factors:

- The value of the product to customers.
- The intensity of competition.
- The bargaining power of the producers relative to their suppliers.

Industry analysis brings all three factors into a single analytic framework.

### Analyzing Industry Attractiveness

Tables 3.1 and 3.2 show the profitability of different US industries. Some industries (such as tobacco, pharmaceuticals, and medical equipment) consistently earn high rates of profit; others (such as iron and steel, nonferrous metals, airlines, and basic building materials) have failed to cover their cost of capital. The basic premise that underlies industry analysis is that the level of industry profitability is neither random nor the result of entirely industry-specific influences – it is determined by the systematic influences of the industry's structure. The US pharmaceutical industry and the US steel industry not only supply very different products, they also have very different structures, which make one highly profitable and the other a nightmare of

TABLE 3.1 The Profitability of US Industries, 1999-2002

INDUSTRY	MEDIAN ROE 1999-2002 (%)	INDUSTRY	MEDIAN ROE 1999–2002 (%)	
Pharmaceuticals	26.8	Trucking, Truck Leasing		
Tobacco	22.0	Energy	10.8	
Household and Personal		General Merchandisers	10.5	
Products	20.5	Utilities: Gas and Electric	10.5	
Food Consumer Products	22.8	Food and Drug Stores	10.3	
Diversified Financials	18.5			
Medical Products and		Equipment	10.0	
Equipment	18.8	Wholesalers: Food and	1010	
Beverages	17.3	Grocery	10.0	
Securities	16.5	Motor Vehicles and Parts	9.8	
Scientific, Photographic,		Home Equipment, Furnishings	9.5	
and Control Equipment	16.3	Railroads	9.0	
Saving Institutions	16.0	Mail, Package, and Freight	0.0	
Commercial Banks	15.8	Delivery	8.8	
Food Services	15.5	Pipelines	8.5	
Engineering, Construction	14.3	Hotels, Casinos, Resorts	8.0	
Publishing, Printing	14.3	Insurance: Life and Health	7.6	
Petroleum Refining	14.3	Real Estate	7.3	
Apparel	13.5	Building Materials, Glass	7.0	
Computer Software	13.5	Temporary Help	6.5	
Mining, Crude-Oil Production	13.5	Metals	6.0	
Computer and Data Services	13.3	Semiconductors and Other		
Furniture	13.3	Electronic Components	5.8	
Electronics, Electrical		Insurance: Property and		
Equipment	12.8	Casualty	5.3	
Chemicals	12.8	Food Production	5.3	
Specialty Retailers	12.3	Telecommunications	3.5	
Automotive Retailing		Forest and Paper Products	3.5	
and Services	11.8	Network and Other	3.0	
Computers, Office		Communications		
Equipment	11.5	Equipment	(4.0)	
Healthcare	11.0	Airlines	(34.8)	

Source: Fortune 1000 by Industry.

**STRATEGY CAPSULE 3.1** Chewing Tobacco, Sausage Skins, and Slot Machines: In Praise of Niche Markets

**UST Inc.** (formerly US Tobacco) has been the most profitable company in the S&P500 over the past 10 years with return on equity frequently topping 100%. Even in 2002, when an antitrust litigation resulted in a \$1.2 billion charge against earnings, UST succeeded in earning a return on capital employed of 38%. What's the secret of UST's success? It's simple – it controls 78% of the US market for "smokeless tobacco" (chewing tobacco and snuff), with brands such as Skoal, Copenhagen, Long Cut, and Red Seal. Despite its association with a bygone era of cowboys and rural poverty, chewing tobacco has been a growth market over the past two decades with a surprisingly large number of young consumers. UST's long-established brands, its distribution through tens of thousands of small retail outlets, and the unwillingness of major tobacco companies to enter this market (due to the poor image and social unacceptability of the product) have made UST's market position unassailable. Federal controls on the advertising of smokeless tobacco products have buttressed UST's market position by making it more difficult for would-be entrants to establish their brands.

**Devro plc** is based in the Scottish village of Moodiesburn. It supplies collagen sausage skins ("casings") worldwide. "From the British 'Banger' to the Chinese Lap Cheong, from the French Merguez to the South American Chourizo, Devro has a casing to suit all product types." Although badly hit by scares over "mad cow" disease and foot-and-mouth disease, Devro's 60% of the world market for collagen casings including 94% of the UK market, 83% of the Australian market and 40% of the US market has allowed it to ride the difficult market conditions of the late 1990s.

**United Game Technology** (UGT) is the world's dominant manufacturer of slot machines for casinos and other locations where gambling is permitted. With a continuous flow of new gaming machines – 2002 product launches included Elvira: Mistress of the Dark, Hundred Play Draw Poker, and Ms Little Green Men – UGT's US market share exceeded 70%, and it established market leadership in a number of European countries, including the UK. With leadership in mechanical and electronic gaming technologies, a raft of patents, and close relations with the casino companies supported by its policy of leasing rather than selling machines, UGT market leadership appeared unchallengeable. During 1999 to 2002, UGT earned an average return on equity of 61%.

Sources: www.ustinc.com, www.devro.plc.uk, www.igt.com.

of industry structure which result in both earning dismal rates of profit. Some of the most attractive industries are those which supply a niche product – the limited markets for such products often mean dominance by just one or two companies (see Strategy Capsule 3.1).

The underlying theory of how industry structure drives competitive behavior and determines industry profitability is provided by industrial organization (IO) economics. The two reference points are the *theory of monopoly* and the *theory of perfect competition*, which form two ends of the spectrum of industry structures. A single firm protected by barriers to the entry of new firms forms a monopoly in which it can appropriate in profit the full amount of the value it creates. By contrast, many firms supplying an identical product with no restrictions on entry or exit constitute perfect competition: the rate of profit falls to a level that just covers firms' cost of capital. In the real world, industries fall between these two extremes. The US market

TABLE 3.3 The Spectrum of Industry Structures

	Perfect Competition	Oligopoly	Duopoly	Monopoly	
Concentration	Many firms	A few firms	Two firms	One firm	
Entry and Exit Barriers	No barriers	Significant barriers		High barriers	
Product Differentiation	Homogeneous product (Commodity)	Potential for product differentiation			
Information Availability	No impediments to information flow	Imperfect availability of information			

for chewing tobacco is close to being a monopoly; the Chicago grain markets are close to being perfectly competitive. Most manufacturing industries and many service industries tend to be oligopolies: they are dominated by a small number of major companies. Table 3.3 identifies some key points on the spectrum. By examining the principal structural features and their interactions for any particular industry, it is possible to predict the type of competitive behavior likely to emerge and the resulting level of profitability.

#### Porter's Five Forces of Competition Framework

Table 3.3 identifies four structural variables influencing competition and profitability. In practice, there are many features of an industry that determine the intensity of competition and the level of profitability. A helpful, widely used framework for classifying and analyzing these factors is the one developed by Michael Porter of Harvard Business School.<sup>2</sup> Porter's Five Forces of Competition framework views the profitability of an industry (as indicated by its rate of return on capital relative to its cost of capital) as determined by five sources of competitive pressure. These five forces of competition include three sources of "horizontal" competition: competition from substitutes, competition from entrants, and competition from established rivals; and two sources of "vertical" competition: the bargaining power of suppliers and buyers (see Figure 3.2).

The strength of each of these competitive forces is determined by a number of key structural variables, as shown in Figure 3.3.

## Competition from Substitutes

The price customers are willing to pay for a product depends, in part, on the availability of substitute products. The absence of close substitutes for a product, as in

Bargaining power of suppliers

INDUSTRY
COMPETITORS

Threat of new entrants

Rivalry among existing firms

Bargaining power of buyers

BUYERS

FIGURE 3.2 Porter's Five Forces of Competition framework

the case of gasoline or cigarettes, means that consumers are comparatively insensitive to price (i.e., demand is inelastic with respect to price). The existence of close substitutes means that customers will switch to substitutes in response to price increases for the product (i.e., demand is elastic with respect to price). E-commerce has provided a new source of substitute competition that has proved devastating for a number of established businesses. The travel agency industry in Europe and North America has been pushed to the brink of ruin by the growth of on-line reservations systems operated by specialists such as Expedia and Travelocity and by the airlines directly.

The extent to which substitutes limit prices and profits depends on the propensity of buyers to substitute between alternatives. This, in turn, is dependent on their price-performance characteristics. If city-center to city-center travel between Washington and New York is 50 minutes quicker by air than by train and the average traveler values time at \$30 an hour, the implication is that the train will be competitive at fares of \$25 below those charged by the airlines. The more complex the needs being fulfilled by the product and the more difficult it is to discern performance differences, the lower the extent of substitution by customers on the basis of price differences. The failure of low-priced imitations of leading perfumes to establish significant market share reflects, in part, consumers' difficulty in recognizing the performance characteristics of different fragrances.

SUPPLIER POWER Factors determining power of suppliers relative to producers; same as those determining power of producers relative to buyers - see "Buyer Power" box. THREAT OF ENTRY INDUSTRY RIVALRY THREAT OF SUBSTITUTES ■ Economies of scale Concentration Absolute cost Diversity of competitors Buyer propensity to advantages ■ Product differentiation substitute Capital requirements Excess capacity and Relative prices and Product differentiation exit barriers performance of ■ Access to distribution Cost conditions substitutes channels Government and legal barriers ■ Retaliation by established producers **BUYER POWER** Price Sensitivity Bargaining Power Cost of product Size and concentration relative to total cost of buyers relative to producers Product Buyers' switching costs differentiation Buyers' information Competition ■ Buyers' ability to between buyers backward integrate

FIGURE 3.3 The structural determinants of the Five Forces of Competition

# Threat of Entry

If an industry earns a return on capital in excess of its cost of capital, that industry acts as a magnet to firms outside the industry. Unless the entry of new firms is barred, the rate of profit will fall toward its competitive level. The US bagel industry, for example, faced a flood of new entrants in 1996, which caused a sharp diminution of profit prospects.<sup>3</sup> The threat of entry rather than actual entry may be sufficient to ensure that established firms constrain their prices to the competitive level. Only American Airlines offers a direct service between Dallas-Fort Worth and Santa Barbara, California, for example. Yet, American may be unwilling to exploit its monopoly position if other airlines can easily extend their routes to cover the same two cities. An industry where no barriers to entry or exit exist is *contestable*: prices and profits