

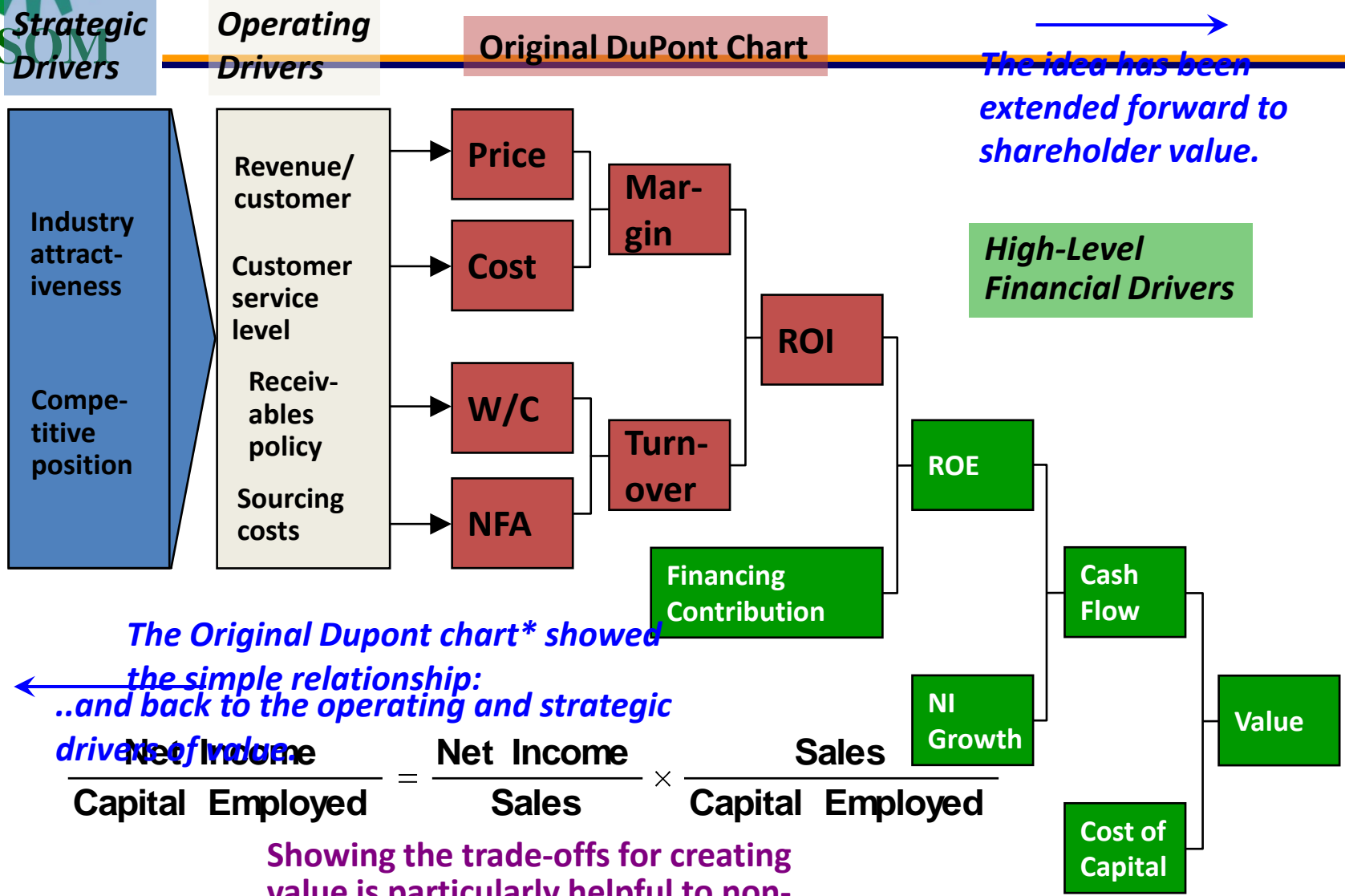
Analysis of External Environment

- Value
- Competitive forces
- Value net
- Strategy groups
- Industry life cycle
- Role of macro environment
- Key success factors

The United States Steel Industry

- Impact that competitive forces have on industry behavior and profitability
- Concepts about market segmentation and strategic groups
- Changing nature of competition over an industry's life cycle
- Influence that external environments can have on firm performance

- Measure
 - ARR - RONW/ ROCE
 - ERR - EVA
- A function of
 - Industry effect
 - Positioning effect



The idea has been extended forward to shareholder value.

High-Level Financial Drivers

The Original Dupont chart* showed the simple relationship: ..and back to the operating and strategic drivers

$$\frac{\text{Net Income}}{\text{Capital Employed}} = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital Employed}}$$

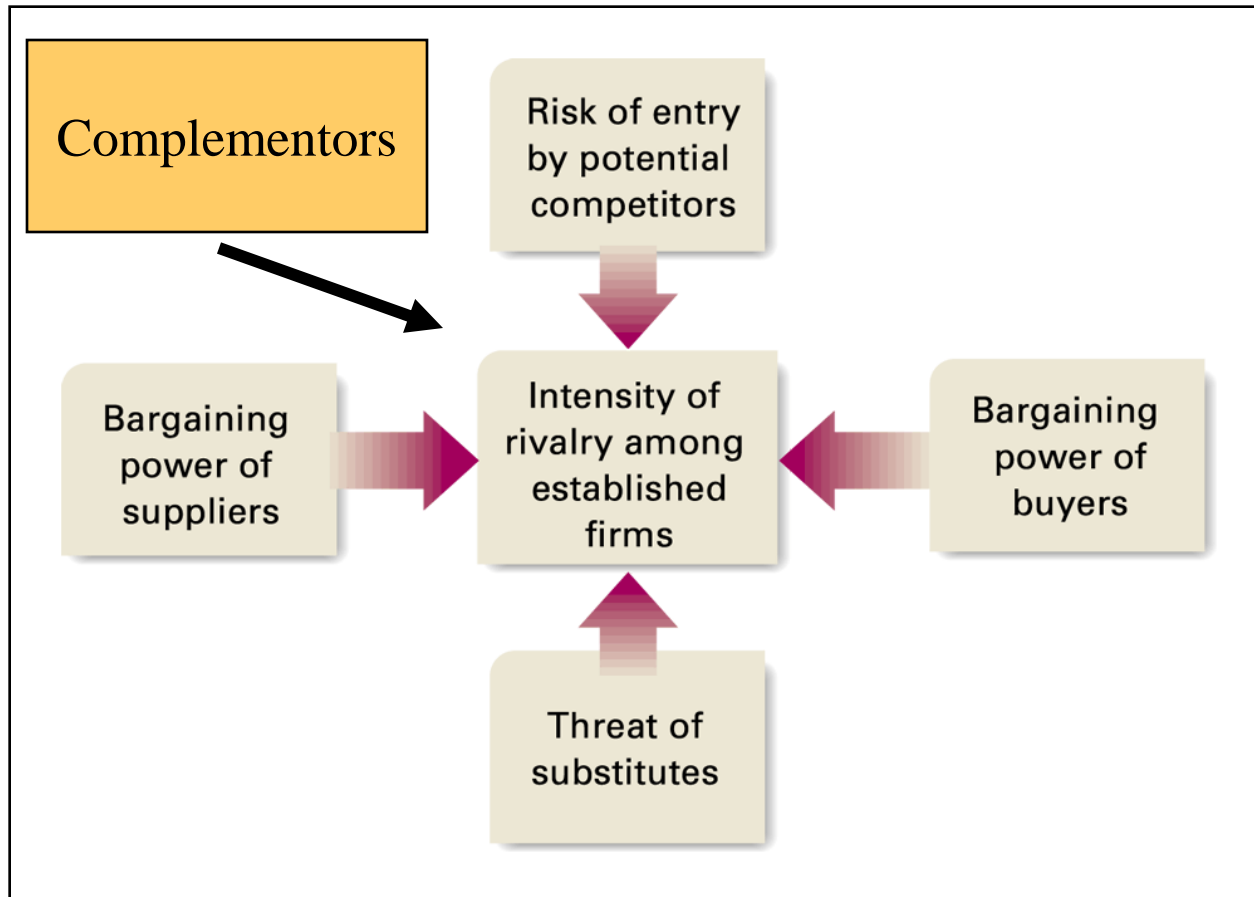
Showing the trade-offs for creating value is particularly helpful to non-financial managers.

* Invented in 1919 by a Dupont engineer who joined the finance department

- Market: Group of firms that compete to supply a particular service
 - Micro level approach customers' choice
- Criteria for defining markets
 - Product markets
 - Demand side substitutability – positive cross-price elasticity of demand
 - Supply side substitutability
 - Geographic markets
 - Geographic substitutability

- If one firm's strategic choice adversely affects the performance of another they are competitors
- A firm may have competitors in several input markets and output markets at the same time
- Competition and markets
 - Perfect competition, Oligopoly, Duopoly & Monopoly
- Measuring market structure
 - N Firm concentration ratio
 - Herfindahl index

Porter's Five Forces Model



How the Five Forces Shape Competition within an Industry

- The stronger that each of these five forces is, the more limited is the ability of established companies to raise prices and earn greater profits within their industry.
 - A weak competitive force
 - may be viewed as an opportunity as it allows company to earn greater profits
 - A strong competitive force
 - may be viewed as a threat as it depresses industry profits
 - Strength of forces may change as industry conditions change

- Barriers to entry
 - Supply-side economies of scale
 - Demand-side benefits of scale
 - Incumbency advantage independent of scale
 - Brand loyalty
 - Customer switching cost
 - Capital requirement
 - Govt. Regulation
- Perception about reaction of incumbents

Circumventing Entry Barriers into the Soft Drink Industry

Power of Suppliers: A supplier group is powerful if

- It is more concentrated than the industry it sells to
- Industry participants face switching costs in changing suppliers
- Suppliers offer products that are differentiated.
- There are no substitutes to what the supplier group provides.
- The supplier group can credibly threaten to integrate forward into the industry.
- The supplier group does not depend heavily on the industry
- E.g., Wal-Mart's Bargaining Power over Suppliers

The Power of Customers

Customers are Powerful if

- They have clout relative to industry participants and especially
- They emphasize price reductions as the means to exercise their clout

A customer group has clout if:

- It is concentrated or purchase in volumes that are large relative to the size of a single vendor.
- The industry's products are standard or undifferentiated
- Buyers face few switching costs in changing vendors.
- Buyers have a credible threat of integrating backward to produce the industry's product themselves if vendors are too profitable

A customer group is price sensitive if

- The products it purchases from the industry represent a significant fraction of its cost or expenditures
- The customer group earns low profits, is strapped for cash, or is otherwise under pressure to trim its purchasing costs
- The quality of the buyers' products or services is little affected by the industry's product
- The buyer's overall costs are not significantly affected by the industry

The Threat of Substitutes

- A substitute performs the same or a similar function as an industry's product but by a different means.
- limit an industry's profit potential by placing a ceiling on the prices that the companies in an industry can charge
- Substitute products that deserve the most strategic attention are those that
 - are subject to trends improving their price-performance trade-off with the industry's product, or
 - are produced by industries reaping high profits that may erode with competition

Rivalry among Existing Competitors

- Degree rivalry
 - the basis on which companies compete – mainly price
 - the intensity with which they compete

Industry competition gravitates to price if

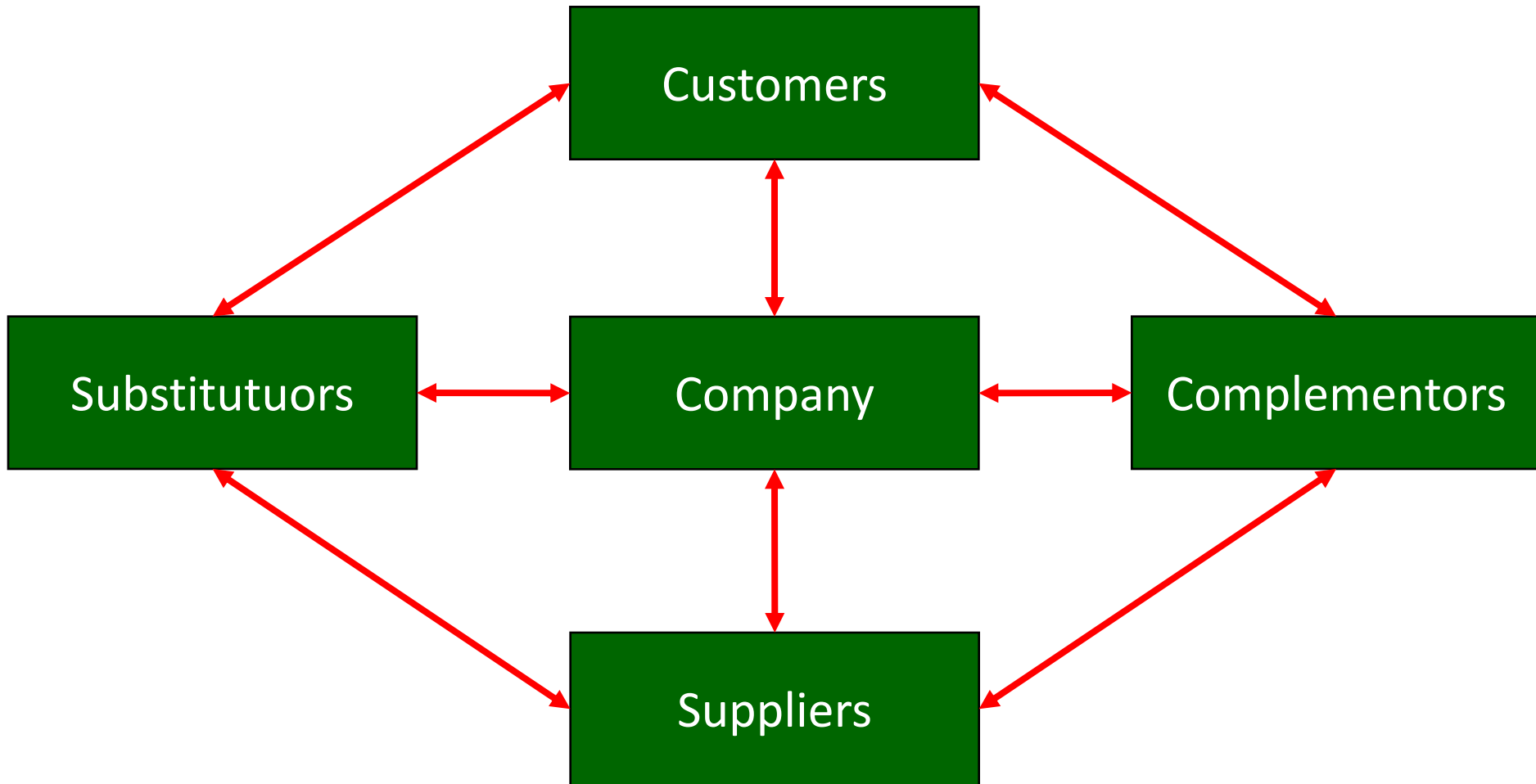
- The product or service lacks differentiation or switching costs
- Fixed costs are high and marginal costs are low
- Capacity must be expanded in large increments
- The product is perishable

Intensity of competition is greatest if

- Competitors are numerous or are roughly equal in size and power
- Industry growth is slow
- Exit barriers are high
- Rivals are highly committed to the business but have diverse approaches, origins, and “personalities.”
- E.g., Price Wars in the Breakfast Cereal Industry

From Competition to Cooperation

The Value Net



“Five Forces” and “Value Net”

- The five forces framework tends to view other firms - competitors, suppliers or buyers - as threats to profitability
- In the Value Net model (Brandenberger and Nalebuff) interactions between firms can be positive or negative
- Firms cooperate
 - in setting industry standards that facilitate industry growth
 - in lobbying for favorable regulation or legislation
 - with their suppliers to improve product quality and thus boost demand
 - with their suppliers to improve productive efficiency
 - with buyers/suppliers to improve inventory management

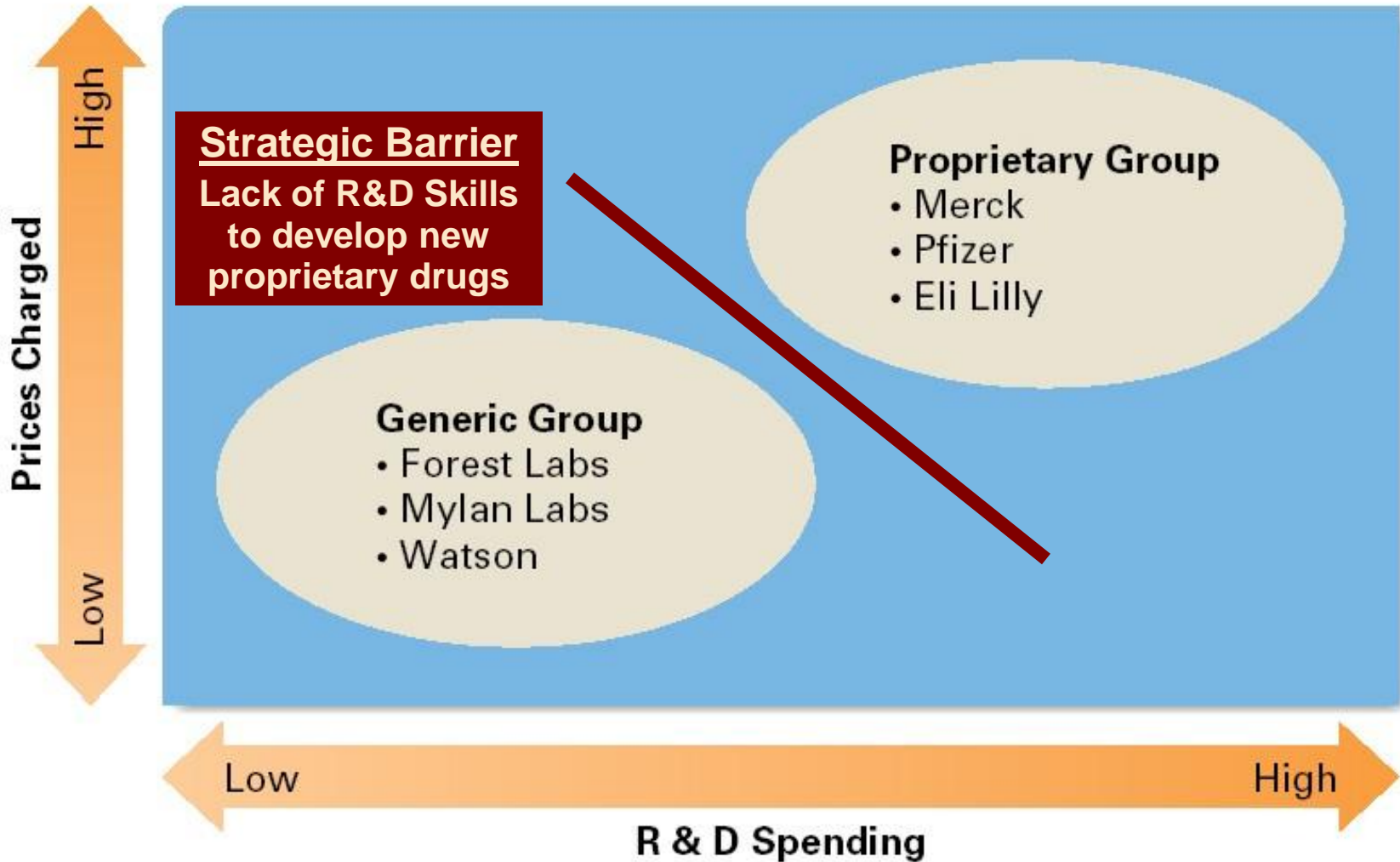
Value Net Illustration: DVD

- When DVD was introduced, sales were lack luster and DIVX was a major threat
- Then manufacturers cut prices on some models and advertised heavily
- Other members of the value net chipped in
 - Movie studios released popular titles in DVD format and priced them moderately
 - Retailers promoted the DVD hardware and software

Strategic Groups Within Industries

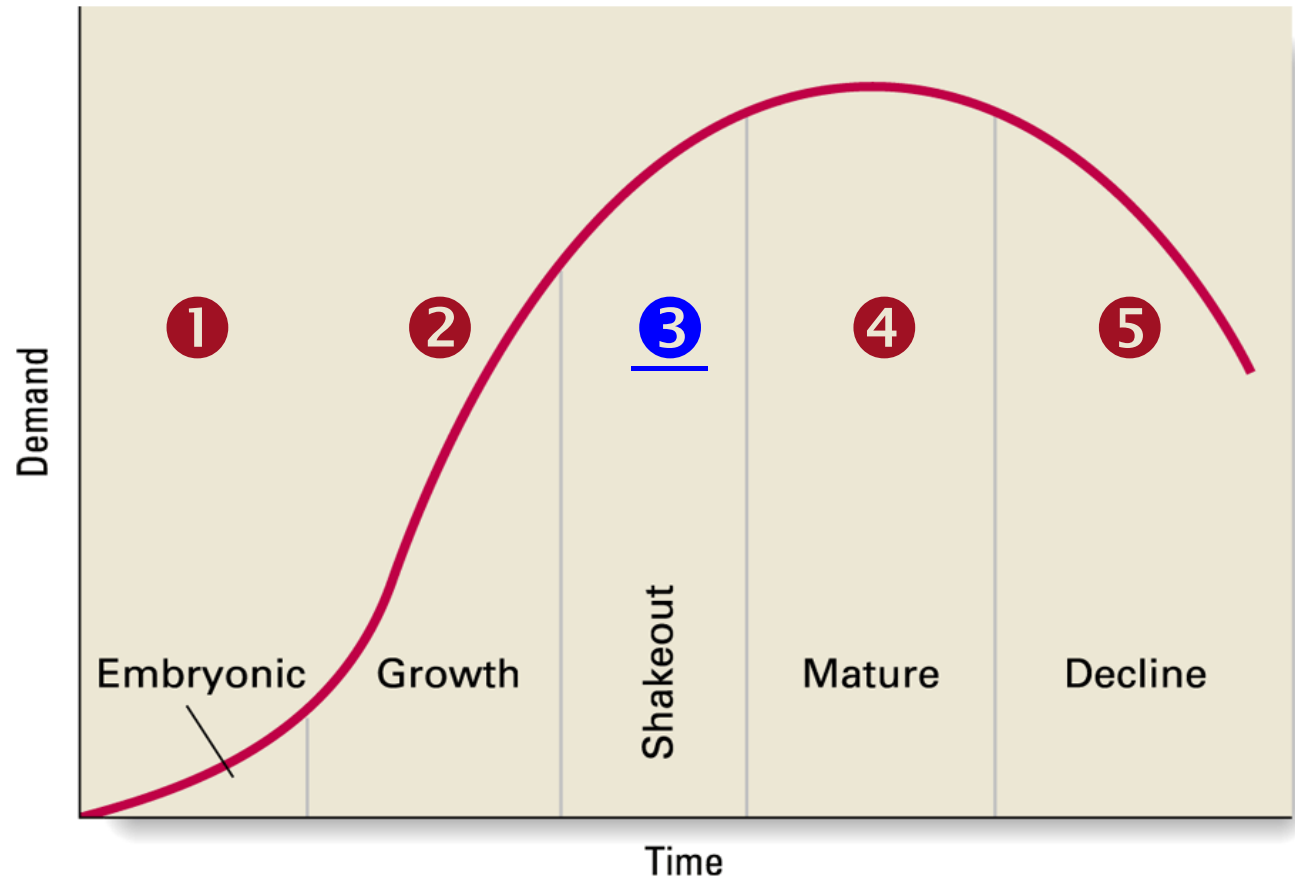
- Groups of firms that follow a similar business model
- Implications of Strategic Groups
 - The closest competitors are within the same strategic group and may be viewed by customers as substitutes for each other.
 - Each strategic group can have different competitive forces and may face a different set of opportunities and threats.
- Mobility Barriers – factors within an industry that inhibit the movement of companies between strategic groups
 - Include barriers to enter another group or exit existing group

Strategic Barriers in the Pharmaceutical Industry



Stages in the Industry Life Cycle

Strength and nature of five forces change as industry evolves



The Driving Forces of Industry Evolution

BASIC CONDITIONS

INDUSTRY STRUCTURE

COMPETITION

Customers become more knowledgeable & experienced

Customers become more price conscious

Quest for new sources of differentiation

Products become more standardized

Diffusion of technology

Production becomes less R&D & skill-intensive

Production shifts to low-wage countries

Price competition intensifies

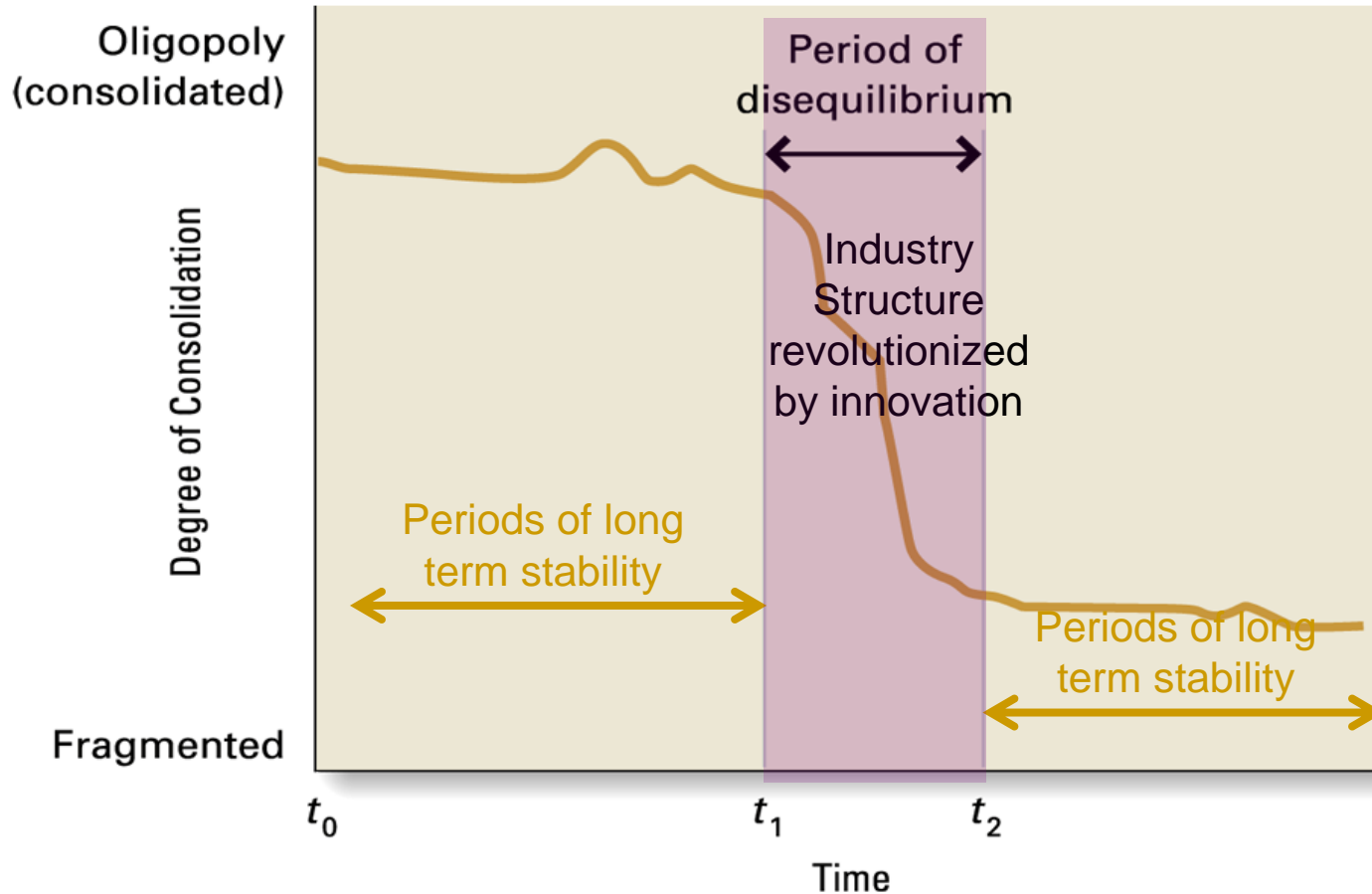
Excess capacity increases

Demand growth slows

Distribution channels consolidate

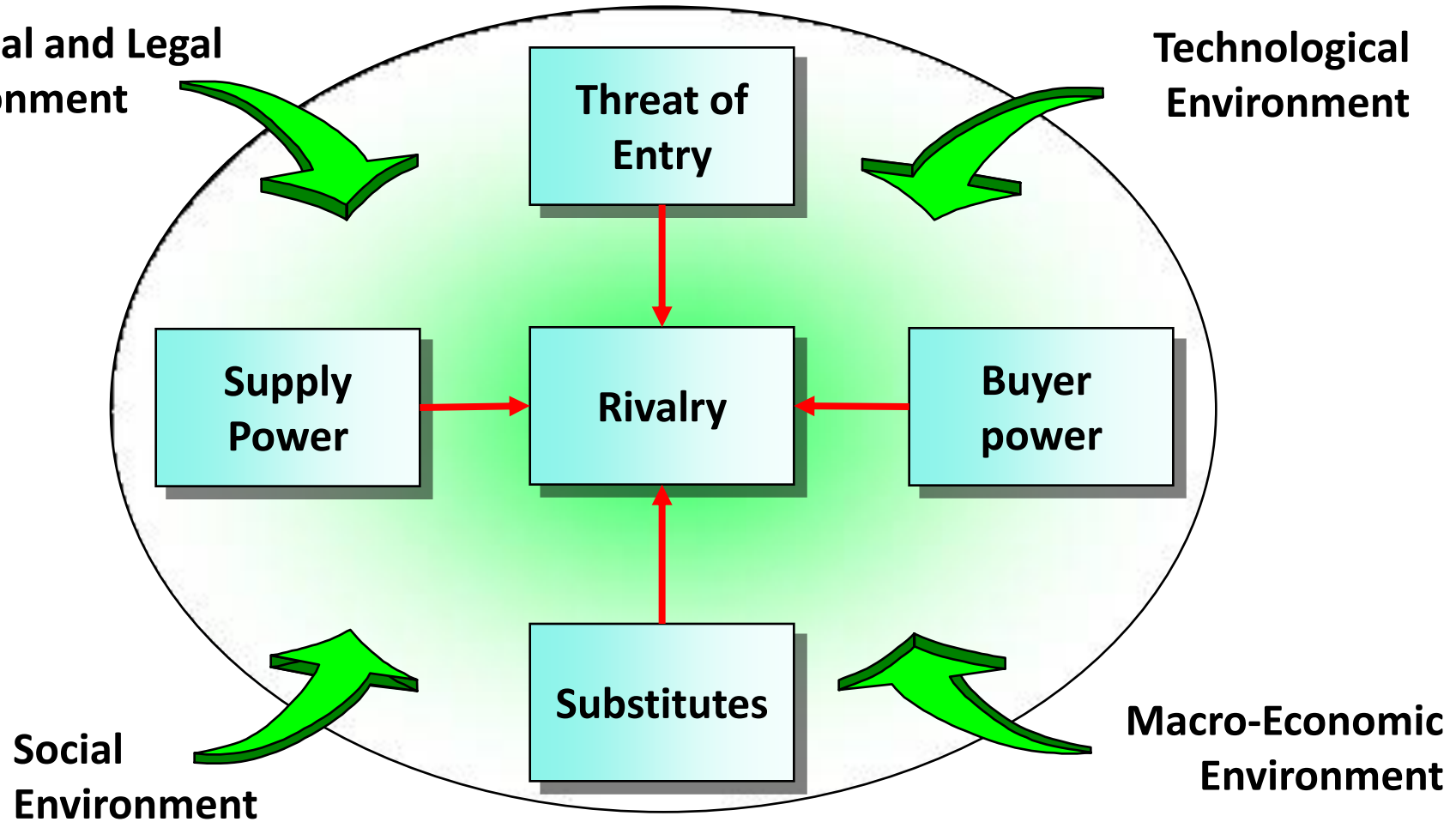
Bargaining power of distributors increase

Punctuated Equilibrium and Competitive Structure

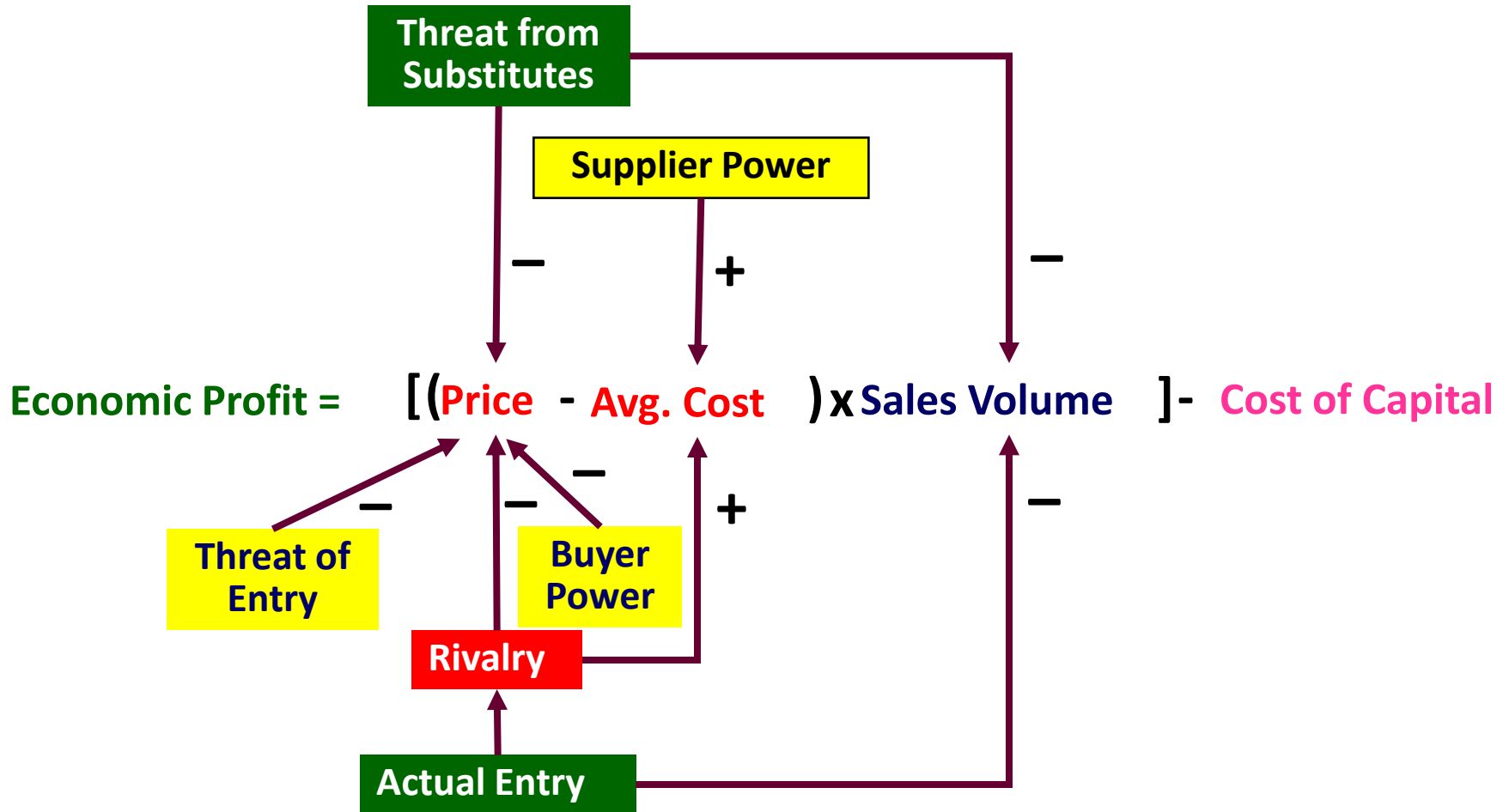


Political and Legal Environment

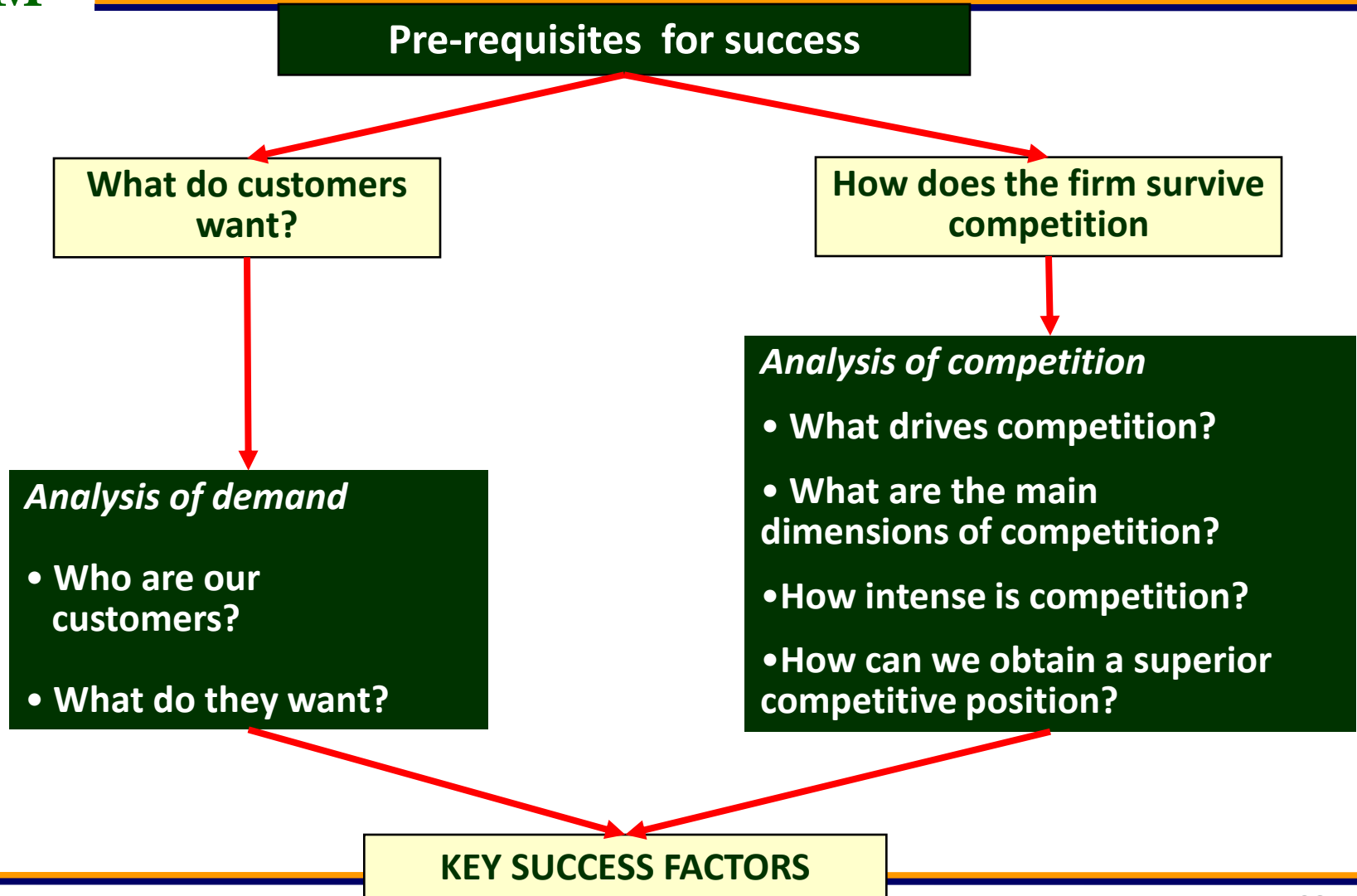
Technological Environment



Applying Five - Forces Analysis



Identifying Key Success Factors



The United States Beer Industry

the competitive structure of the industry using Porter's competitive forces model

- *Risk of Entry*: economies of scale
- *Bargaining power of suppliers*: commodity type supply input
- *Bargaining power of buyers*: Low brand loyalty
- *Substitutes*: Many substitutes are in existence for mass-market beer, such as micro-brewed beer, wine, and spirits.
- *Rivalry among established companies*: aggressive price competition, and intense brand competition, weakening demand conditions