UNIT 5 COMPETITIVE FORCES

Objectives

After reading this unit you should be able to understand the:

- competitive environment ;
- competitive forces of the competitive environment;
- Porter's five forces framework to analyze competitive environment;
- process for analyzing the external environment; and
- concepts of strategic groups and scenario planning.

Structure

5.1 INTRODUCTION

In unit 4, we discussed the first level of the external analysis i.e. understanding of the macro environment, which have an influence on the success or failure of an organisation's strategies. However, it is the immediate competitive environment which also influences an organisation and therefore has to be understood alongside the general environment. The impact of the changes of the macro environment is felt on the organisation and its strategies through their influences on the competitive forces of the competitive environment. Hence an indepth understanding of the industryís competitive character is the next important step for an organization as part of its external analysis.

5.2 COMPETITIVE ENVIRONMENT

The competitive environment refers to the situation which Organisation's face within its specific area of operation, and this can be understood at an industry level or with respect to smaller groups called **Strategic groups** (Refer appendix). Generally understood, an industry in the economy is recognized as a group of firms producing the same principal product or more broadly the group of firms producing products that are close substitutes for each other and in a given industry different organisations have different intermediate basis of understanding its relative position with respect to other organisations in the industry.

Organisation within an industry with similar strategic characteristics, following similar strategies or competing on similar bases are called strategic groups. These characteristics for a particular group will be different from those in other strategic groups in the same industry or sector. There may be many different characteristics, which distinguish between strategic groups. For example size, breadth of product range, geographical coverage, quality or service levels or marketing spend. The concept of strategic groups when used helps in understanding who are the most direct competitors of any given organization and on what basis competitive rivalry is likely to take place within each strategic groups.

There are competitive forces beyond direct rivals which shape up the competitive environment that can be better understood with the Five forces framework discussed below.

Activity 1

Take the automobile industry in India and identify strategic groups which may be possible to form using few parameters discussed above.

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5.3 PORTER'S FIVE FORCES FRAMEWORK

The five forces framework developed by Michael Porter is the most widely known tool for analyzing the competitive environment, which helps in explaining how forces in the competitive environment shape strategies and affect performance. The framework as shown in Figure 5.1 suggests that there are competitive forces other than direct rivals which shape up the competitive environment. These competitive forces are as follows:

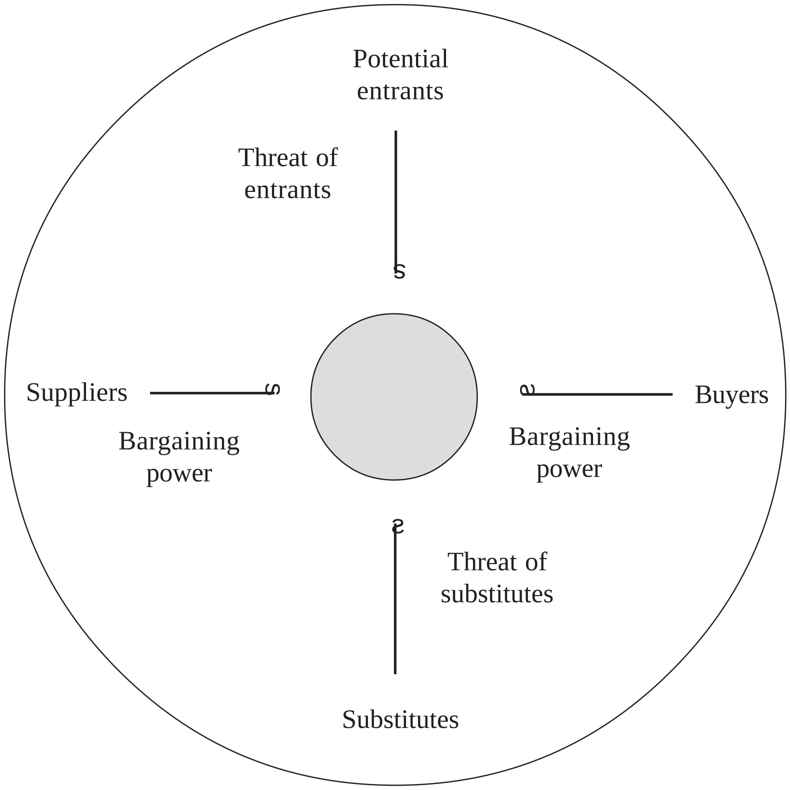
1) The rivalry among competitors in the industry
2) The potential entrants
3) The substitute products
4) The bargaining power of suppliers
5) The bargaining power of buyers

However, these five forces are not independent of each other. Pressures from one direction can trigger off changes in another which is capable of shifting sources of competition. In the following section each of these five forces are discussed in detail as to understand how each of these forces affect an Industry's environment so that one can identify the most appropriate strategic position within the industry.

1) Threat of New Entrants

Entry of a firm in and operating in a market is seen as a threat to the established firms in that market. The competitive position of the established firms is affected because the entrants may add new production capacity or it may affect their market shares. They may also bring additional resources with them which may force the existing firms to invest more than what was not required before. Altogether the situation becomes difficult for the existing firms if not threatening always and

Five Forces Analysis



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For marketing learners

Figure 5.1. Five Forces Analysis

Source: Adapted from M.E. Porter, Competitive Strategy, Free Press, 1980, p. 4

therefore they resort to raising barriers to entry. These barriers are intended to discourage new entrants and this may be done by organisations, be in any one or more ways, as discussed below:

a) ***Economies of Scale*:** Firms which operate on a large scale get benefits of lower cost of production because of the economies of scale. Since the new firm normally would start its operation at a smaller scale and therefore will have a relatively higher cost of production, its competitive position in the industry gets adversely affected. This barrier created through large scale of operation is not only applicable for production side but it can be extended to advertising, marketing, distribution, financing, after sales customer service, raw materials, purchasing and Research and Development as well. For example, you would have noticed in durable industry the kind of investments which players like Samsung and LG do on advertising and promotions normally and specially during events like World Cup cricket match. This makes it nearly impossible for any new third player to launch and sustain such intensive and investment driven maketing attack.

b) ***Learning or Experience Effect*:** The theory explaining the experience curve or the learning curve suggests that as firms produce they grow more efficient and this brings them cost benefits. The efficiency levels achieved is an outcome of the experience, which teaches the organization better ways of doing things. This again keeps any new entrant at a disadvantage.

c) ***Cost Disadvantage Independent of Scale*****:** New entrants may face disadvantages which are independent of the operations. It may be on account of the lack of proprietary product knowledge such as patents, favourable access to raw material, favourable locations, existing plants built and equipped years earlier at lower costs, lower borrowing costs etc.

d) ***Brand benefits*****:** Buyers are often attached to established brands. Differences in physical or mere perceived value make existing products unique and the new entrants have to tire out to beat such brands and change the mindset of the customers.

e) ***Capital Requirements*****:** High investments required for a start up in any business is another deterrent for new entrants bringing down the possibility of increased competition.

f) ***Switching Costs*****:** Switching costs, which is nothing but the expenses (financial or psychological) which a customer incurs in switching from one seller to another. Cases where such an expense is higher, new entrants find it difficult to establish or survive. Such costs may be because of a strong brand association or the comfort level a customer may be enjoying or it may be on account of a particular technology like Windows operating systems which most customers use and therefore will find it inconvenient to switch to a system like LINUX so easily.

g) ***Access to Distribution Channel*****:** Any such critical activity like distribution channel in the business can be a barrier for the entrants when accessibility to them is found to be difficult. Most existing firms in FMCG industry are found to have a strong favourable distribution channels which is very difficult to penetrate. For example in India you can think of HLL which commands a deeply entrenched distribution network.

h) ***Anticipated Growth*****:** Incumbents in a rapidly growing market are less likely to respond to a new entrant when the market's growth offers enough opportunities to share. But a new entrant position will be opposite in a slowly growing market.

In addition to the above, few general entry barriers exist in each industry's case, for example, regulatory policies, tariffs and international trade restrictions are few such additional factors.

Activity 2

Identify any industry of your choice and illustrate the possibility of new entrants entering in that industry and why? Do you see any barriers being raised by the existing players?

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2) Bargaining Power of Suppliers

Business organizations have a large dependency on suppliers and the latter influence their profit potential significantly. Suppliers' decisions on prices, quality of goods and services and other terms and conditions of delivery and payments have significant impact on the profit trends of an industry. However, suppliers' ability to do all these depends on the bargaining power over buyers.

Suppliers' bargaining power would normally depend on:

a) ***Importance of the Buyer to the Supplier Group:*** The size of the supplies taken by a particular buyer is likely to put the buyers in a relatively advantageous position. The same may be found true if the supplier tends to get an image advantage by supplying to a particular firm. Consequently in dealing with such buyers, suppliers' bargaining power is naturally reduced. Just opposite happens when buyer is not so important to the supplier and the latter then is less likely to offer favourable terms to win or retain the customer.

b) ***Importance of the Supplier's Product to Buyers*:** Here the position may just be opposite of the above situation where suppliers have a better bargaining power coming from their sheer size or image.

c) ***Greater Concentration Among Suppliers than among Buyers*:** An industry, which is largely dominated by a few large firms is a highly concentrated industry. Such few firms hold greater power with them as the proportion of the industry's total output is in hands of such large firms. This gives such firms greater power over those who do business with them. The converse is true when industry has low concentration in suppliers. A higher concentrated supplier position may be possible on account of the sources of raw materials available, R & D or patent rights available with fewer firms.

d) ***High Switching Costs for Buyers*:** In this case buyers suffer because of the suppliers' advantageous position or by the nature of supplies itself, the buyers have to face a higher switching cost.

e) ***Credible Threat of Forward Integration by Suppliers*:** Suppliers in a given situation may see an opportunity in moving up the value chain and may seriously think of getting into the business of what its buyers have been doing till now. Any indication of that nature from supplier side puts the buyers at the receiving end as they feel threatened because of a new player in that market and of losing an assured source of supplies. A recent example may be of Reliance which has decided to move from exporation and refining of oil to seeling of oil through its own retail petrol pumps.

Activity 3

Identify any industry of your choice and study the suppliers for the industry. Examine their strengths using the parameters discussed above as compared to buyers.

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3) Bargaining Power of Customers

Customers with a stronger bargaining power relative to their suppliers may force supply prices down or demand better quality for the same price and may demand more favourable terms of business. For instance, there will always be a difference in the bargaining power between an individuals buying different construction material like cement, steel or bricks and a real estate builder buying them for the number of properties he may have been building over so many years.

Few of the following facts attach greater power to buyers:

a) **Undifferentiated or Standard Supplies:** A supplier, given the nature of products it supplies, may have a very limited choice in providing any differentiated products and this enables a customer to get the deal at the most favourable terms. In a perfectly competititve market situations with large number of suppliers, prices automatically are at their lowest.

b) **Customer's Price Sensitivity:** Customer's buying behaviour vary with respect to their sensitivity to prices. Depending on how important the item is for the customer's usage and proportion he may be spending on the item concerned, buyers' sensitivity to price varies. Any customer with high price sensitivity gains advantage in its bargaining power.

c) **Accurate Information about the Cost Structure of Suppliers:** A more informed customer is capable of negotiating with suppliers. Whenever such customers notice a decline in the supplier's costs they would always bargain for a proportional decrease in price. This aspect is more relevant in today's context of global markets where cost benefits can come from anywhere in the world at any point in time for various reasons. There may be a general decline in prices of a product in world market because of a glut situation or somewhere some new discoveries may have pulled the prices down.

d) **Greater Concentration in Buyer's Industry than in Supplier's Industry and Relatively large Volume Purchase:** This means that buyers are large and more powerful than suppliers. Government departments like police department when negotiating for large orders of security weapons or intelligence equipments will necessarily command a greater hold than its supplier as there will be only few number of such institutions buying them at a given point of time.

e) **Credible threat of Backward Integration by Buyers:** Different from forward integration which suppliers tend to attempt at, buyers in order to hold their position stronger in the market may integrate in backward manner. This will mean that the buyer extends sitself to the previous stage of manufacturing or distribution for which it had been dependent on suppliers till now. An example could be of an entertainment channel which airs programmes outsourced from organizations producing them outside, get into the business of producing its programmes in house.

4) Threat of Substitutes

Often firms in an industry face competition from outside industry products, which may be close substitutes of each other. For example, with the new technologies in place now the electronic publishing are the direct substitutes of the texts published in print. Similarly, newspaper find their closest substitutes in their online version, though it may be a smart strategic move to position them as complementary products.

However, the competitive pressure, which any industry may face, depends primarily on three factors:

1) whether the substitutes available are attractively priced;
2) whether buyers view substitutes available as satisfactory in terms of their quality and performance;
3) how easily buyers can switch to substitutes.

Generally it is observed that the availability and acceptability of substitutes determine an upper price limit to a product. When relative prices of the product in question rise above that of the substitute products, customers tend to switch away from them.

Activity 4

Identify any industry of your choice and study the substitutes for the products of the industry.

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5) Competitive Rivalry

The level of rivalry is minimum in a perfectly competitive market where there are large number of buyers and sellers and the product is uniform with everyone. Same is true for a monopoly market where there is only one player and the type of product is also one. However in case of oligopoly or monopolistic competition, where you will find few players and the market conditions allow them to differentiate their products and services, competition if found to be fierce. Few of the following factors explain the level of rivalry:

a) ***The Stability of Environment*****:** An unstable environment is likely to call for a hyper-competitive situation and of the several factors that affect stability could be technological innovation, changes in government regulations, customers' profile and their needs. In an industry which witnesses high movements in terms of entry or exit, the rules of the game may change too frequently. One of such instances of fierce competition could be noticed on account of the onslaught of new technologies like CDMA affecting the general environment of telecom industry in India. The entry of Reliance India Mobile with CDMA technology intensified the rivalry between telecom players to such an extent that the government had to intervene through its institution, Telecom Regulatory Authority of India (TRAI).

b) ***The Life Expectancy of Competitive Advantage*****:** There are industries for example consumer electronics or white goods in which the fruits of innovations do not last longer and hence the companies do not even bother to patent them. This has an adverse implication for the stability of the competitive environment leading to intense rivalry. Length of innovation cycle, patent protection or switching costs between rivals are few factors, which may impact the life expectancy of competitive advantage.

c) ***Characteristics of the strategies pursued by competitors*****:** This also has or may have an impact on the general approach to rivalry. For example, in a market segmented approach on part of the competitor leads to lesser rivalry situation. Also the kind of goals, which competitors pursue has an impact on the rivalry. Competitors pursuing the goal of increased market share will lead to increased rivalry again.

Lastly, few implications can be picked up from the five forces framework itself. Lower threats to entry or a higher possibility for substitutes have the potential of increasing rivalry. A lower engagement between supplier will result into a lesser rivalry. So will be the effect when buyers face higher switching costs.

In an overall assessment, two critical observations regarding rivalry can be made here. First a powerful competitive strategy employed by one rival can greatly intensify the competitive pressure on other rivals. Second, the frequency and rigor with which rivals use any or all competitive weapons at their disposal can be a major determinant of whether the competitive pressures associated with rivalry are cutthroat, fierce, strong, moderate or weak.

Activity 5

Identify two separate industries, which you may consider are relatively stable and unstable respectively. Comment on the nature of rivalry, which may be existing in those industries. A similar exercise you may repeat considering the life expectancy of competitive advantages.

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5.4 PROCESS FOR ANALYZING THE EXTERNAL ENVIRONMENT

Let us now see the process for analyzing the external environment. This consists of three steps which are as follows:

Step 1: Identifying the firms – on industry as a whole or there may be sub focus groups called strategic groups. (see appendix)

Step 2: Intelligence gathering or environmental scanning on the general environment of the industry or strategic group.

Step 3: Organizational Environment Information-Scenario planning is a process suitable for the purpose and form the best inputs for the strategy formulation process.

The information can be gathered from the following sources:

1) Internal

ii) Newspaper/Magazine/Net

iii) Government

iv) Survey Secondary Database

v) Customer and Suppliers

vi) Competition

Using these sources the environmental analysis for any organization can be done.

5.5 SUMMARY

The immediate competitive environment influences an organization and therefore has to be understood alongside the general environment. The five forces model help us in understanding any industry by identifying the strengths of each of the five forces and the nature of competitive pressure that each force generates. It also enables an understanding of the overall structure of competition. The competitive structure of an industry sounds unattractive when rivalry among firms are strong, there exists low entry barriers and substitutes are more common along with, when both suppliers and buyers command a higher bargaining power. In case of reverse position the competitive structure is found to be lucrative.

It is therefore a challenging task for managers to imitate and formulate strategies which can effectively neutralize the negative impact on the competitive structure of industry generated by these forces.

5.6 KEY WORDS

Competitive Environment refers to the situation which organization's face within its specific arena of operation.

Bargaining Power is decided by the relative strengths or weaknesses between two players or partners.

Learning or Experience Effect suggests that as firms produce they grow more efficient and this brings them cost benefits.

Switching Costs are the expenses (financial or psychological) which a customer incurs in switching from one seller to another.

Concentration in an Industry: An industry largely dominated by a few large firms is a highly concentrated industry.

5.7 SELF ASSESSMENT QUESTIONS

1) Explain the competitive environment for any industry and discuss external analysis framework of that industry.
2) Explain briefly the five forces framework and use it for analyzing competitive environment of any industry of your choice.
3) How the nature of markets determine the competitive rivalry between firms? Explain with suitable examples.
4) Write short notes on Strategic groups and Scenario Planning.

5.8 REFERENCES AND FURTHER READINGS

Johnson Gerry & Scholes Kevan. (2004), *Exploring Corporate Strategy.* Sixth edition, Prentice-Hall of India, New Delhi.

Jr. Thompson A. Arthus, III Strickland A.J. (2003), *Strategic Management, Concepts and Cases*, Thirteenth edition, Tata McGraw Hill Publishing, New Delhi.

Miller Alex, *Strategic Management*, Third edition, Irwin Mcgraw Hill.

Appendix

1. Strategic Groups

They are conceptual clusters in the sense that they are grouped together for purposes of improving analysis and understanding competition within their industry. They do not necessaryily belong to any formal group such as an industry, trade, association or any strategic alliances and they do not necessarily differ in their average profitability.

Research has shown that industries vary greatly in the similarity of their firms in terms of strategies pursued and we need to analyze the two types of industries differently. For industries, which are considered heterogeneous comprising multiple strategic groups, it would be inappropriate and misleading to combine different strategies groups in the same environmental analysis. For example in a four-wheeler automobile industry, strategic groups can be thought of Cars, Multi-utility Vehicles (MUVs) or Sports car vehicles.

Strategic groups are merely conceptual clusters in order to facilitate analysis and therefore the categorizing of firms may be inway which is beneficial or insightful. Size of the firms may be one of the criterion when analysis is to be understood how giants differ from smaller firms. Geographic distribution, breadth of markets, products/ service quality may be few others to determine strategic groups. Furthermore it often makes sense to use different combinations of strategic dimensions to more precisely indentify groups.

In a homogeneous industry it is reasonable for all the competitors to be considered as part of the same strategic group in a single industry-wise analysis.

Competitive Intelligence

It is the information which is relevant to strategy formulation regarding the environmental context within which a firm competes. Such intelligence has several uses:

a) Providing description of the competitive environment that inform strategist and guide strategy formulation;

b) Challenge common assumption about the competitive environment;

c) Forecasting future development in the competitive environment;

d) Identifying and compensating for exposed competitive weaknesses;

e) Determining when a strategy is no longer viable or sustainable;

f) Indicating when and how strategy should be adjusted to changing competitive environment.

2. Scenario Planning

Scenarios are tools for ordering one’s perceptions about alternative future environments in which today’s decisions might be framed. In practice, scenarios resemble a set of stories, written or spoken, built around carefully constructed plots. These stories can express multiple perspectives on complex events; scenarios give meaning to these events. Scenarios are powerful planning tools precisely because the future is unpredictable. Unlike traditional forecasting or market research, scenarios present alternative images instead of extrapolating current trends from the present. Scenarios also embrace qualitative perspectives and the potential for sharp discontinuities that econometric models exclude. Consequently, creating scenarios requires decision-makers to question their broadest assumptions about the way the world works so they can foresee decisions that might be missed or denied.

Within an organization, scenarios provide a common vocabulary and an effective basis for communicating complex – sometimes paradoxical – conditions and options. Good scenarios are plausible and surprising, they have the power to break old stereotypes, and their creators assume ownership and put them to work. Using scenarios is rehearsing the future. By recognizing the warning signals, the threats and opportunities that is unfolding, one can avoid surprises, adapt, and act effectively. Decisions which have been pre-tested against a range of what may offer are more likely to stand the test of time, produce robust and resilient strategies, and create distinct competitive advantage. Ultimately, the result of scenario planning is not a more accurate picture of tomorrow but better thinking and an ongoing strategic conversation about the future.

Example of Scenario Planning at an Energy Producing Firm

Understanding the business of an energy producing firm and the environment it faces, Scenario planning can be found useful in the following ways:

- Creating alignment between energy situation and firm's vision and purpose. ("What is our 21st century business idea?").
- Sparking innovation and new forms of value creation ("What new products and services might replace the traditional one?").
- It will involve many people wth ability-to-perceive and/or ability-to-act as effective participants in the process.
- It will provide space for multiple interpretations to make sense of what is happening.
- By including people from a broad spectrum of backgrounds, scenario planning will be capable of creating early breakthroughs in perception and understanding, allowing the firm to get grip of the new environment it can't escape from.

Implementation of Scenario Planning

A company wide involvement in Scenario Planning leads to better result in a firm. A cross-functional team is instituted for the identification and monitoring of issues. Employees are encouraged to participate by an incentive based process. The onus of refining and final implementation of the suggestions then lies on the cross functional team. With the following steps indicated, you will be getting a better understanding of the whole process:

STEP 1: Identification of the Issues

Understand the effects of external factors on business and these the factors can be:

- Technology driven (new product, IT based integration)
- Political (deregulation, instability)
- Economic (sudden downturns, boom)
- Competitive positioning (moves from competitors)

Participants need not limit themselves to above mentioned factors only, any factor that may have an impact on the company is acceptable.

STEP 2: Classification of the Issues

- Support the issue identified with reports/propositions/any other method.
- Determine the uncertainty and kind of impact of the issue.

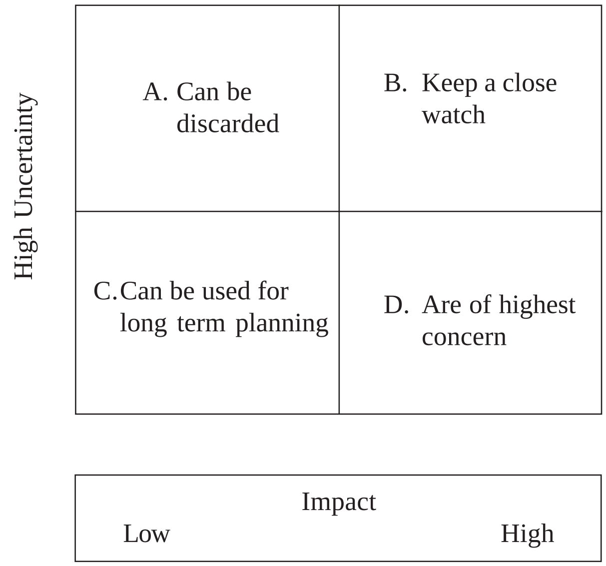

Figure: A graph between uncertainty and impact

STEP 3 Analyzing and Problem Solving

Based on above classification a display board of the issues as per their classification can be used to communicate the issue to all and the following sequence can be taken for analysis and problem solution:

D. category high impact-low uncertainty; highest priority issues, need to be addressed immediately and more cautiously. All employees must first focus on these issues.

B. category high risk issues, need to be observed closely and monitored strictlyi because of high uncertainty involved.

C. category low impact-low uncertainty; these issues can be used for long term planning.

A. category High uncertainty-low impact; because of low impact to the organization and high degree of uncertainty involve, these issues can be altogether discarded.

The analysis and problem solution proposition part can be done on an individual or team basis depending upon the interest of the participant(s). All ideas/reports should then be submitted to the cross functional team for further analysis and implementation.