

Industry Analysis

What makes an industry profitable?

Michael Porter's Five Forces Framework

- Underlying forces that make industries profitable are same across industries
 1. Substitutability
 2. Buyer Power
 3. Seller Power
 4. Competition with Incumbents
 5. Competition with Entrants
- Really an organization tool
 - CS is messy, but at least we can sort what concepts go where
 - Hard part in the real world: **quantifying which ones matter**

Further reading: <https://www.isc.hbs.edu/strategy/business-strategy/Pages/the-five-forces.aspx>

Entry

- Most important is generally **entry**, both actual and potential
 - Looking across industries, **barriers to entry (BTE)** is the unifying feature of profitable industries
- Firms actually create a lot of barriers to entry
 - Not (always) nefariously...
- This point is broadly applicable
 - Lobbying

- Marketing
- R&D

The Forces are Interconnected

We saw in the Cola Wars that marketing affects the other 5Fs, too

- Substitutability (people love their Coke/Pepsi!)
- Bargaining power (why weren't the bottlers profitable?)
- Rivalry (this was the dimension on which they were competing)

Consumer Welfare

- So are these profitable activities that raise BTEs good or bad for consumers?
- Use Cola Wars as an example, think through the pie diagram
 - Marketing pushes out the demand curve for sodas, which increases the size of the pie
 - Good for consumers
 - Marketing increases the barriers to entry, which decreases the slice (%) for consumers
 - Bad for consumers
 - The net effect is ambiguous!
- Other mechanisms are less ambiguous
 - Generally think the 1st effect is bigger than the 2nd effect for R&D
 - Generally think the 1st effect is smaller than the 2nd effect for lobbying

OK, But What About Integration?

∫ No

- We sidestepped a lot of discussion on integration in the Cola Wars
- That's because we're saving that topic for Week 8!
 - Though you can see that the 5F framework touches on a lot of things

- Later weeks are less messy -- deep dives into a single concept

Side Note Example

- For antitrust, biggest weakness of the 5Fs in practice is defining the relevant market
- Entire merger cases are decided by arguing where to draw the line
- See Whole Foods acquiring Wild Oats
 - <https://www.antitrustlawblog.com/2009/04/articles/uncategorized/the-food-fight-is-over-whole-foods-and-ftc-settle-dispute-over-merger-of-organic-markets/>

Takeaways

1. Five Forces helps organize thinking about why an industry is profitable
2. Profits = $f(\text{rivalry}, \text{bargaining}, \dots)$
3. Most important force to understand sustained profits is **entry**
4. Firms create their own **barriers to entry** as a normal part of production

Question for Next Week

- 1 - How can you be successful with an industry?

May the Force be with you...