JOHNSON
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Industry Analysis

Strategy AEM2601

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Industry Analysis = 5 Forces

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- To understand an industry, look for *precise structural features*—why are the following important or not in any given situation:

  - Internal Rivalry
  - Entry
  - Supplier Power
  - Buyer Power
  - Substitutes

Threat Levels

- It is often useful to assign threat levels to the five forces
- Which forces are threatening the profitability of the industry?

high

medium/high

medium

low/medium

low

Industry Analysis

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Rivalry – Airframe Manufacturing

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	↑(high threat because)	↓(low threat because)	
Rivalry	❑ Very comparable product line-up ❑ Large and infrequent orders ❑ Limited market growth ❑ Production assets difficult to liquidate during recession	❑ Incompatibility of parts = differentiation in aftermarket ❑ Order Backlogs and Undercapacity ❑ Small number of firms ❑ Cost benefits of uniform fleet for airlines	medium

How to analyze Internal Rivalry

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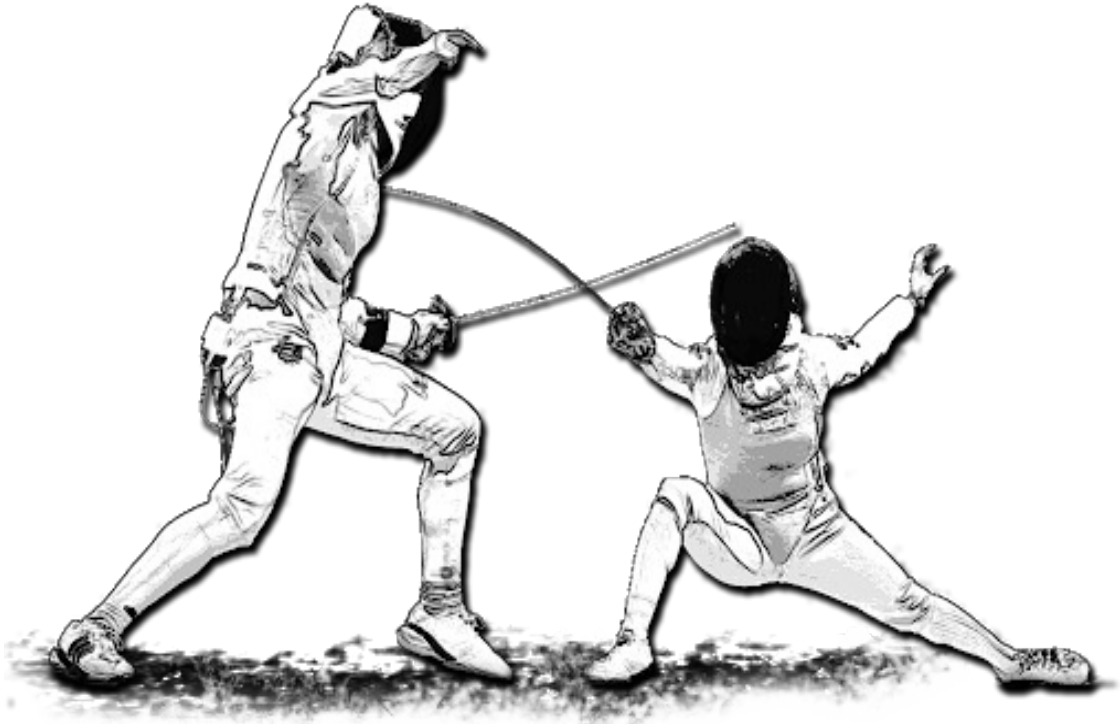
- Many different factors influence the intensity of rivalry, e.g.:
  - The number of firms (industry concentration)
  - Product differentiation
  - Market growth
  - (Excess) capacity
  - Switching costs
  - Exit costs



Factors influencing Rivalry

- Industry Concentration
  - In an industry in which few firms hold large market shares, the incentives to undercut rivals’ prices are weak
- Production Differentiation
  - In an industry in which firms’ products are differentiated, buyers do not only focus on price and, thus, incentives to undercut rivals’ prices are weak
- Switching Costs
  - Buyers face switching costs if switching from their status quo to another product requires an additional investment (of money or time)
  - If there are switching costs, firms have weaker incentives to undercut rivals’ prices

Factors influencing Rivalry

- Excess Capacity
  - A firm has excess capacity if its fixed investments (e.g. in store size/ production plant) allow it to produce/sell more than it currently does
  - If firms have excess capacity, their marginal cost of selling more are low, which implies strong incentives to sell more by undercutting rivals' prices
  - Excess capacity is likely a problem in markets where fixed costs are significant because this means that firms can only expand capacity by taking larger steps
- Exit Costs (only relevant in during recession)
  - Exit costs include the difference between the cost of acquiring an asset and the liquidation value of an asset, plus financial obligations a company owes if it exits a market (without going completely bankrupt)
  - If exit costs are high, firms do not exit an industry even if they make losses

Supplier Power in Streaming

- ❑ What about supplier power in the video on demand streaming industry?

Supplier Power	↑	↓	Low/ medium

	❑ Increasing number of studios and streaming services
	❑ Studios and streaming services demand quantity to keep subscribers
		❑ Studios have many alternatives.
		❑ Market conditions favor variety in terms of actors, genres, preferred short series because
		    ❑ it allows studios to hedge against costly flops (different from box-office)
		    ❑ it allows the recommendation algorithms to select from a greater pool of options	

How to analyze Supplier Power

- Supplier power describes the clout of suppliers over the industry in question
- Supplier power is higher (all else equal) if
  - Suppliers control significant market share
  - Supplier market is more "concentrated"
    - ✓ i.e. there are fewer suppliers than firms in the main industry
    - ✓ Increase in concentration of suppliers raises their power (all else equal)
  - A lack of viable substitutes (to buy from)
  - Suppliers have potential to forward integrate (and lower if you can backward integrate)

LTL Trucking

- Let's understand the LTL market:

  - Is the LTL industry more or less profitable than the FTL industry? Think about entry barriers, which are higher?

LTL Trucking (Yellow)

Entry	↑	↓	low/medium
	❑ Trucks are easy to acquire/rent ❑ Drivers are easy to hire	❑ Network of warehouses required to consolidate shipments ❑ Complex logistics & routing ❑ Large fixed costs require picking up a large market share from incumbent to be profitable	

Analyzing Threat from Entry

- What about the likelihood of entry into our industry?
- Entry barriers:
  - Control of essential resources (natural, IP, …)
  - Economies of scale and scope (in production)
  - (Excess) capacity
  - Switching costs
  - Network effects (In Porter: "demand-side economies of scale")
  - Incumbent advantages (brand image, etc.)
  - Other incumbent advantages (e.g., brand image)
- Threat from entry also depends on possible speed of entry

Network effects on Platforms

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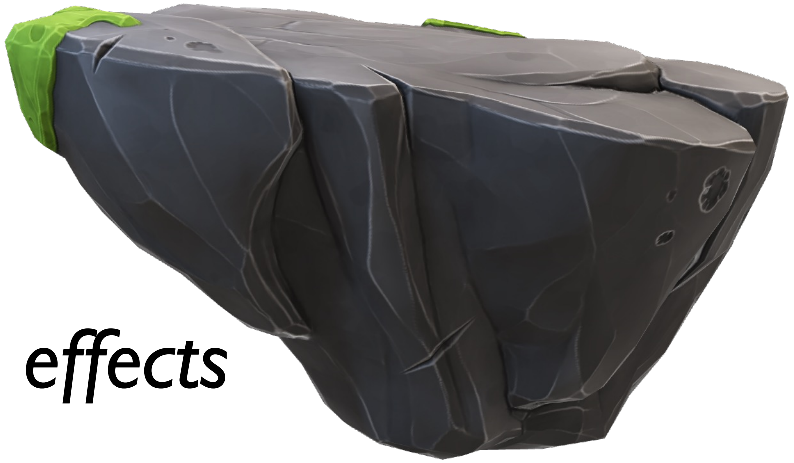
- A platform is a product or service that *intermediates* multiple *sides of a market*
  - It profits by charging one or more sides of this market for transactions
- For example:
  - A newspaper intermediates *readers* and *advertisers*
  - Credit Cards intermediate *merchants* and *customers*
  - Facebook intermediates social *media consumers and advertisers*
  - Uber intermediates *passengers and drivers*
  - Videogame consoles intermediate *gamers and developers*
  - Groupon intermediates *business and deal-seeking customers*
  - DogVacay intermediates *dog owners and dog walkers*
- Platforms and standards exhibit *network effects*



Types of Network Effects

- Platforms exhibit *network effects*
- Network effects can be *same-sided*: users care about how many users are on "their side" of the market
  - WhatsApp users care about the number of WhatsApp users
  - Dropbox users care about the number of Dropbox users
- Network effects can be *cross-sided*: users care about how many users are on "the other side" of the market
  - Apple iOS users want more apps
  - Uber passengers want more Uber drivers
- Networks effects can lead to exponential growth and constitute a significant barrier to entry

Industry Analysis – Takeaways

- Five Forces: you compete for profits with rivals <u>and</u>
- Potential <u>Entrants</u>
  - The likelihood of entry depends on barriers to entry
- <u>Suppliers/Buyers</u>
  - Power of suppliers/buyers depends on market share, concentration, viable substitutes, vertical integration, regulation, etc.
- Providers of <u>Substitutes</u>
  - The threat from substitutes depends on their viability, availability, price
- 5+1 forces analysis helps understand
  - Which forces pose the greatest threats
  - Which forces can be influenced
  - Where opportunities lie

Preview for next Week

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Core Content: Industry Analysis II

“A lack of competition explains the flaws in American aviation” *The Economist* (2017)