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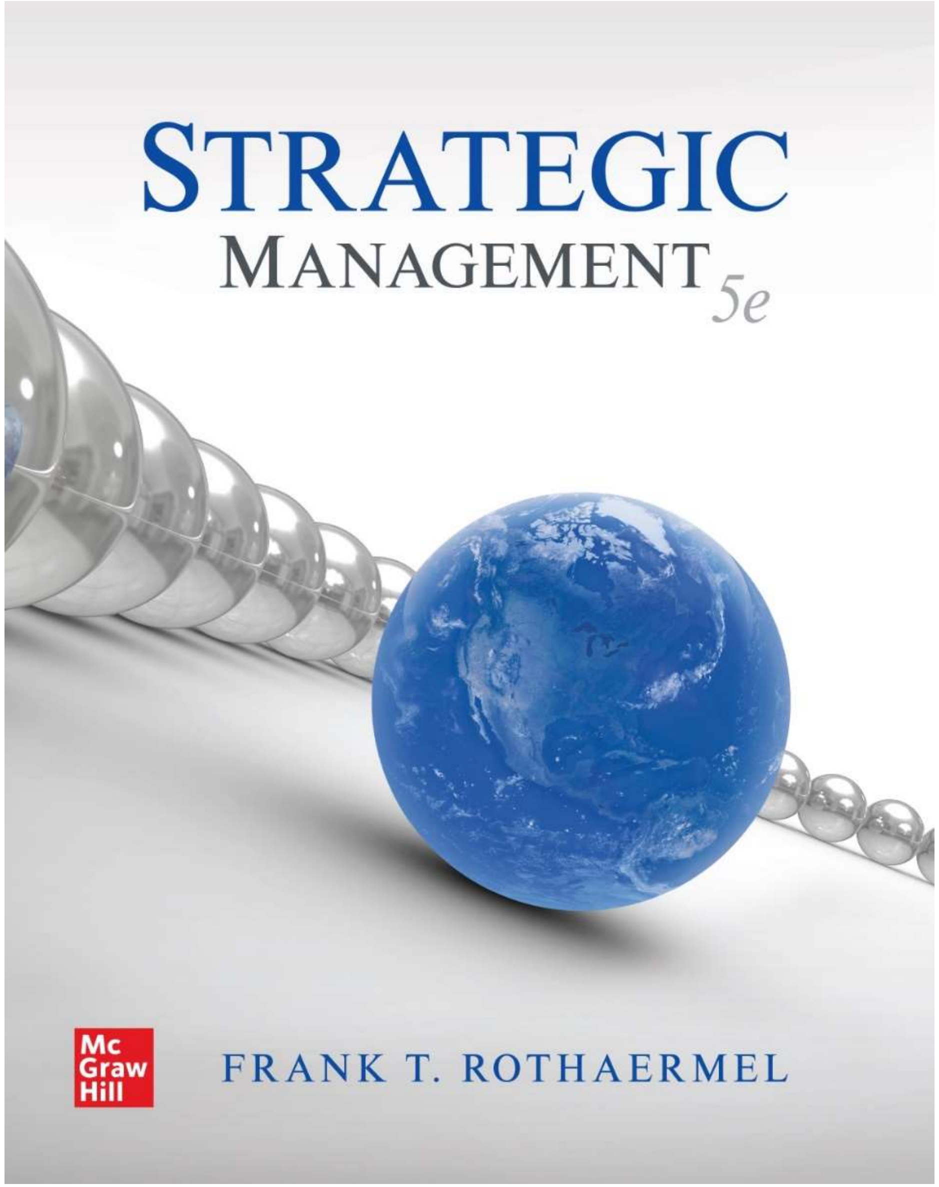
Chapter 3

External Analysis: Industry Structure, Competitive Forces, and Strategic Groups



Learning Objectives

1. Generate a PESTEL analysis to evaluate the impact of external factors on the firm.
2. Differentiate the roles of firm effects and industry effects in determining firm performance.
3. Apply Porter's five competitive forces to explain the profit potential of different industries.
4. Examine how competitive industry structure shapes rivalry among competitors.
5. Describe the strategic role of complements in creating positive-sum co-opetition.
6. Explain the five choices required for market entry.
7. Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.
8. Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

How External Factors Impact a Firm

General environment:

- Managers have little control.
- Macroeconomic factors are included.
- Examples: interest, exchange rates, etc.

Task environment:

- Managers can influence.
- Includes the composition of strategic groups.
- Includes the structure of the industry.

The PESTEL Model

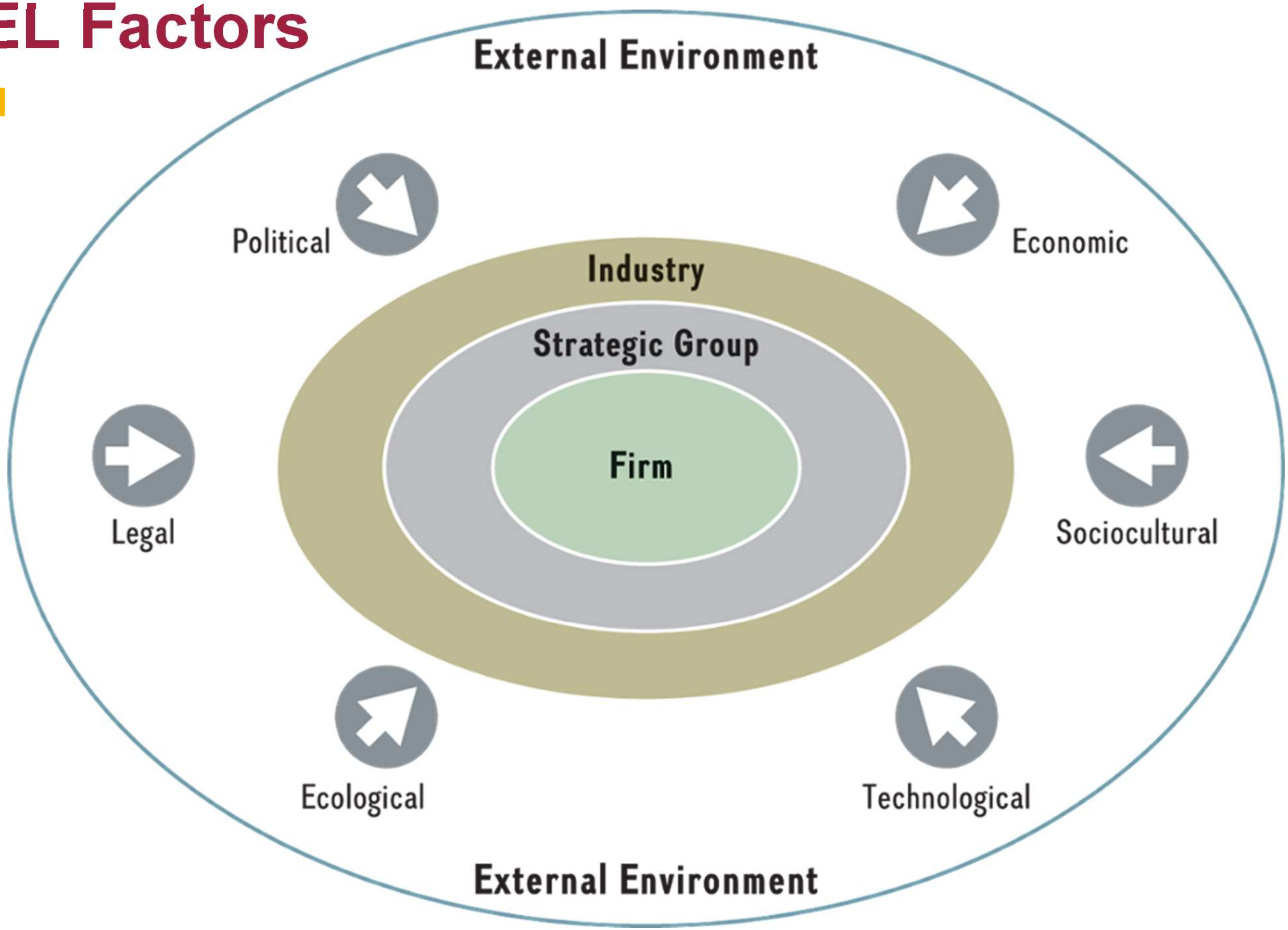
Groups environmental factors into six segments:

1. Political.
2. Economic.
3. Sociocultural.
4. Technological.
5. Ecological.
6. Legal.

A straightforward way to scan, monitor, and evaluate external factors.

The Firm within Its External Environment, Industry, and Strategic Group, Subject to PESTEL Factors

Exhibit 3.1



Political Factors

Processes and actions of government bodies that influence the firm can be shaped through:

- Lobbying.
- Public Relations.
- Contributions.
- Litigation.

Political and legal forces are closely related.

- Political pressure often results in changes in legislation.

Economic Factors

Largely macroeconomic.

Affect economy-wide phenomena.

Examples include:

- Growth rates.
- Levels of employment.
- Interest rates.
- Price stability.
- Currency exchange rates.

Sociocultural Factors

Society's cultures, norms, and values:

- Are constantly in flux.
- Differ across groups.
- Trends should be monitored.

Demographic trends:

- Population characteristics.
- Age, gender, family size, ethnicity, sexual orientation, religion, and socioeconomic class.

Technological Factors

Application of knowledge:

- New processes and products.

Innovations in process technology:

- Lean manufacturing, Six Sigma quality and biotechnology.

Innovations in product technology:

- Smartphones, wearable devices, high-performing electric cars.

Advances in artificial intelligence and machine

Ecological Factors

Broad environmental issues:

- Natural environment.
- Global warming.
- Sustainable economic growth.

The relationship between organizations and the environment can be:

- Adversarial.
- Can provide business opportunities.

Legal Factors

Official outcomes of political processes:

- Laws.
- Mandates.
- Regulations.
- Court decisions.

Many industries have been deregulated.

Legal factors often coexist with or result from political will.

Industry vs. Firm Effects

Industry Effects:

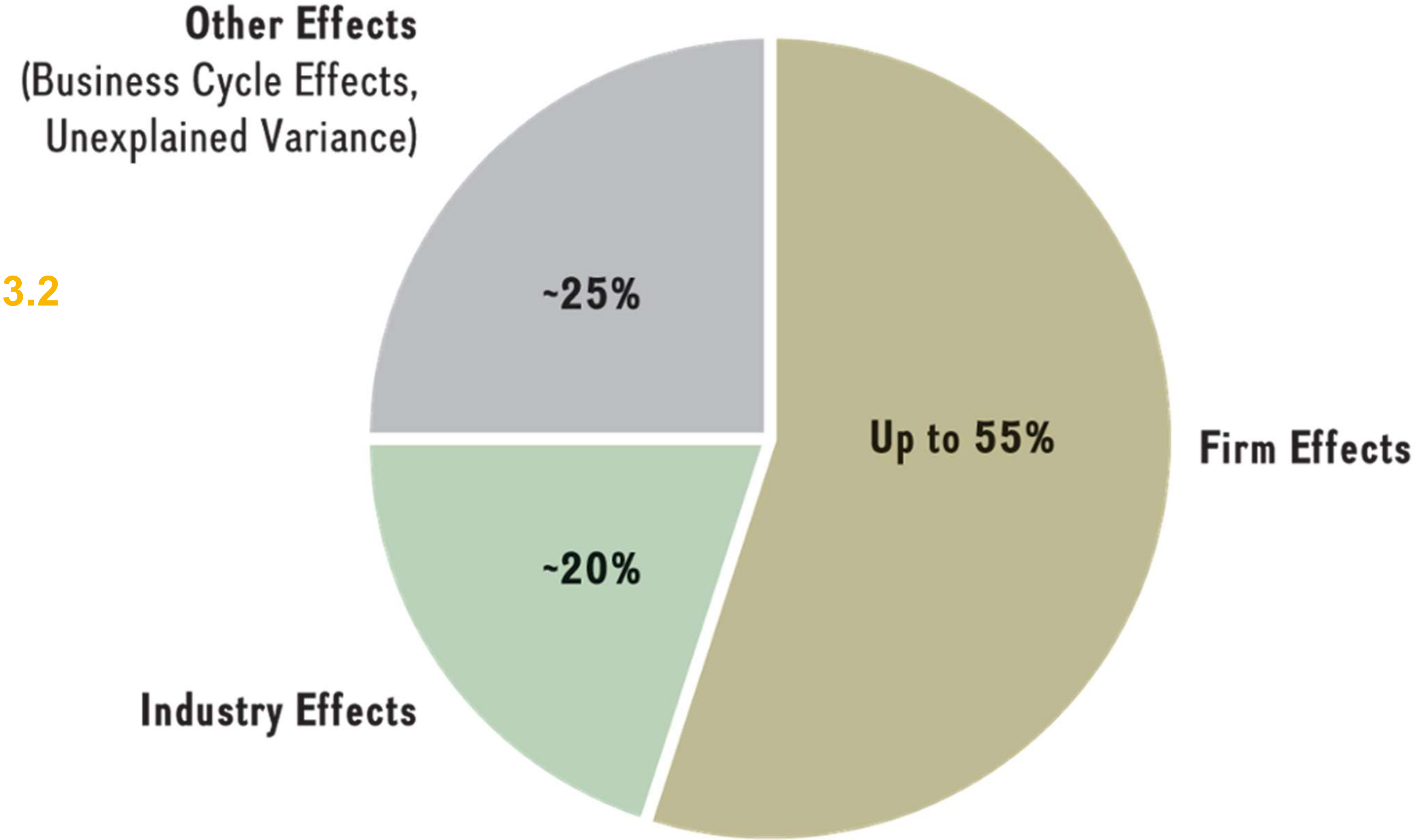
- Describe the economic structure of the industry.
- Elements in common to all.
- Entry and exit barriers, number and size of companies, and types of products and services

Firm Effects:

- Attribute firm performance to the manager’s actions.
- More important than industry effects.

Industry, Firm, and Other Effects Explaining Firm Performance

Exhibit 3.2



Industry and Industry Analysis

Industry:

- Group of incumbent companies.
- Relatively similar suppliers and buyers.
- Similar products and services.

Industry analysis, a method to:

- Identify an industry's profit potential.
- Derive implications for a firm's strategic position.

Strategic Positioning

A firm's ability to:

- Create value for customers (V).
- While containing costs (C).

Goal.

To generate a large gap between:

- The value the firm's product or service creates.
- The cost required to produce it.
- V minus C.

The Five Forces Model

The Five Forces Model helps strategic leaders understand:

- The profit potential of different industries.
- How they can position their firms to gain and sustain competitive advantage.

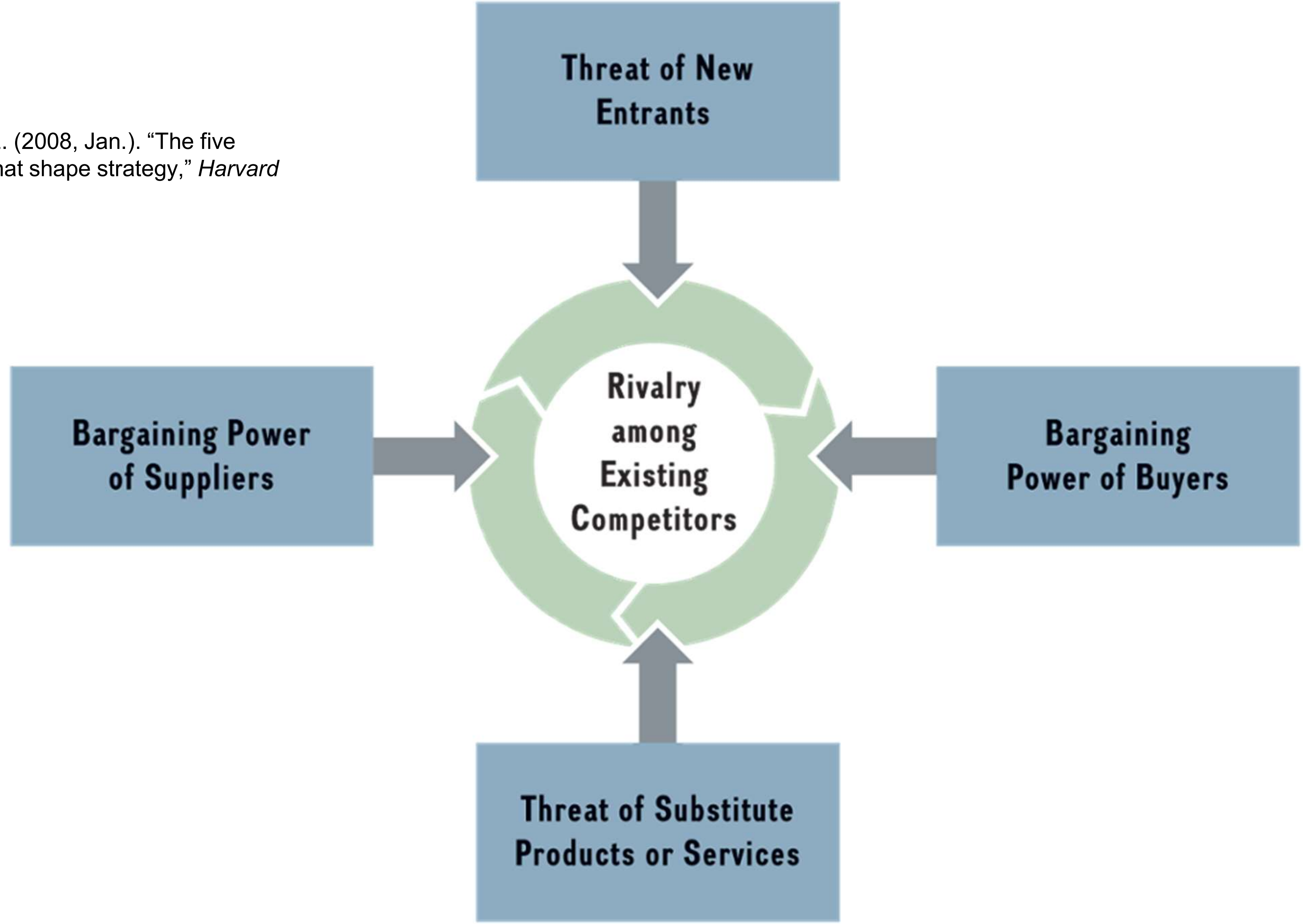
Two key insights about this model:

- Competition is viewed more broadly in the five forces model.
- Profit potential is a function of the five competitive forces.

Porter’s Five Forces Model

Exhibit 3.3

Source: Porter, M. E. (2008, Jan.). “The five competitive forces that shape strategy,” *Harvard Business Review.*



Threat of Entry

The risk that potential competitors will enter an industry:

- Lowers industry profit potential.
- Increases spending among incumbent firms.

Entry barriers:

- Economies of scale.
- Network effects.
- Customer switching costs.
- Capital requirements.
- Advantages independent of size.
- Government policy.
- Credible threat of retaliation.

Power of Suppliers

Pressures that industry suppliers can exert on an industry's profit potential.

Lowers industry profit potential if:

- Suppliers demand higher prices for their inputs.
- Suppliers capture part of the economic value created.

Power of Buyers (Customers)

Lowers industry profit potential if:

- Buyers obtain price discounts, which reduces revenue.
- Buyers demand higher quality / service, which raises production costs.

Situations when buyers are price sensitive:

- The buyer's purchase represents a significant portion of its procurement budget.
- Buyers earn low profits or are strapped for

Buyers are the customers of an industry.

Threat of Substitutes

Meet the same basic customer need:

- In a different way.
- Available from outside the given industry.

Examples:

- Software vs. professional services.
- Energy drinks vs. coffee.
- Videoconferencing vs. business travel.
- Wireless phone services vs. internet-based services (Skype).

Rivalry Among Competitors

The intensity with which companies in the same industry jockey for market share and profitability.

- Can range from genteel to cut-throat.
- The other forces in the model pressure this rivalry.
- The stronger the forces, the stronger the competitive intensity.

Competitive Industry Structure is Defined By

Number and size of competitors.

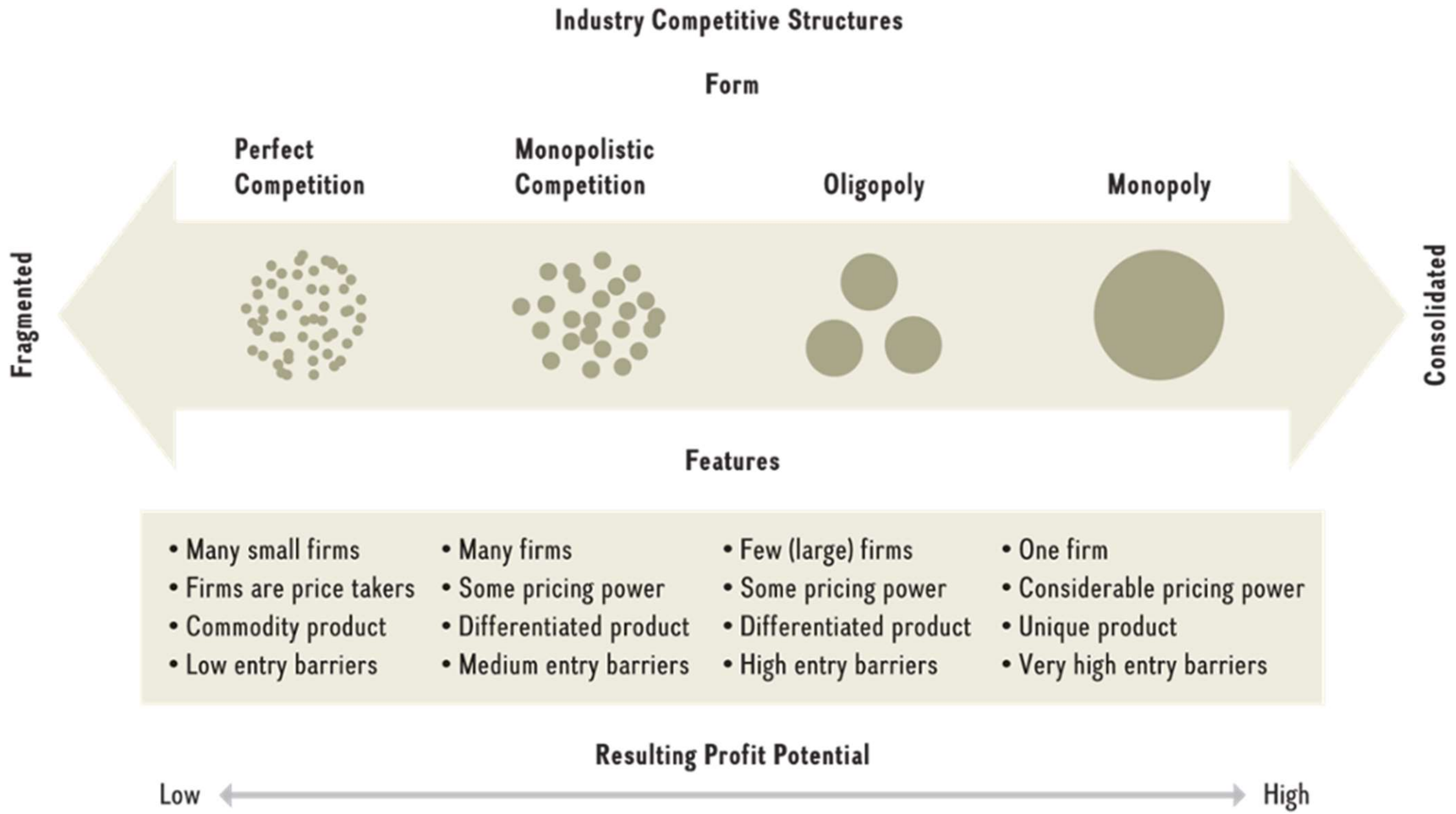
Firm's degree of pricing power.

Type of product or service
(commodity or differentiated product).

Height of entry barriers.

Industry Competitive Structures along the Continuum from Fragmented to Consolidated

Exhibit 3.4



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Industry Growth

Affects intensity of rivalry among competitors.

During periods of high growth:

- Consumer demand rises.
- Price competition among firms decreases.

During periods of negative growth:

- Rivalry is fierce.
- Rivals can only gain at the expense of one another.
- Price discounts, promotional campaigns, and retaliation abound.

Strategic Commitments

Firm actions that are:

- Costly, long-term oriented and difficult to reverse.

Can stem from:

- Large, fixed cost requirements.
- Non-economic considerations.

Affects intensity of rivalry among competitors.

Exit Barriers

Obstacles that determine how easily a firm can leave that industry.

Mainly economic and social factors.

Include fixed costs that must be paid.

Examples: employee health care and retirement benefits.

A Sixth Force: Complements

A product, service, or competency that adds value when used with the original product.

- Complements increase demand for the primary product.
- Enhances the profit potential for the industry and the firm.

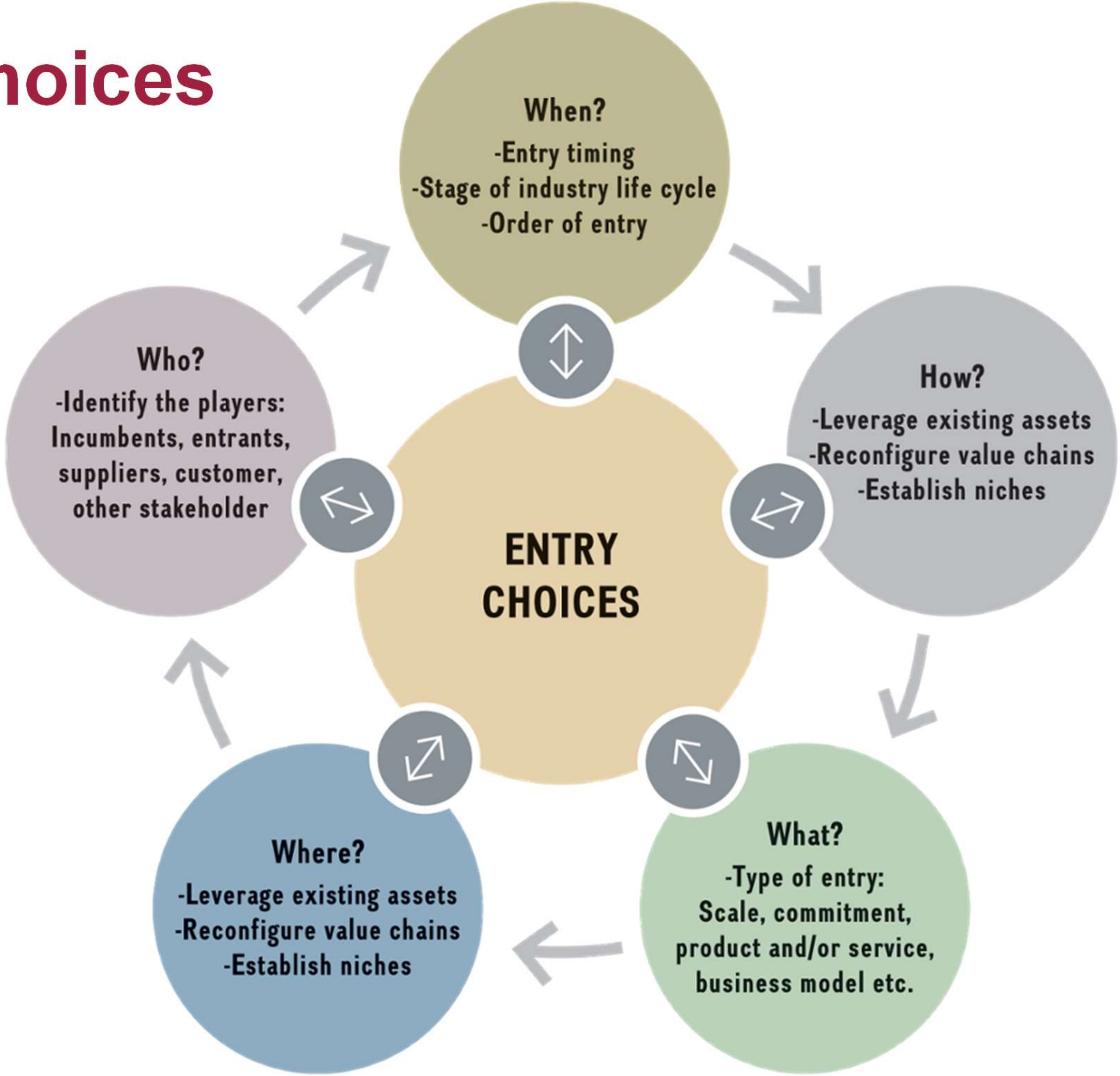
Co-opetition:

- cooperation among competitors to achieve a strategic objective.

Entry Choices

Exhibit 3.6

Source: Based on and adapted from M.A., Zachary, P.T. Gianiodis, G. Tyge Payne, and G.D. Markman (2014), “Entry timing: enduring lessons and future directions,” *Journal of Management* 41: 1409; and Bryce, D.J., and J.H. Dyer (2007, May), “Strategies to crack well-guarded markets,” *Harvard Business Review*: 84–92.



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Industry Dynamics

A weakness of other models is that they are static (point-in-time snapshot).

Industry dynamics provides insight about:

- Changing speed of an industry.
- Rate of innovation.
- Help capture structural changes in the industry.

Industry Convergence

When unrelated industries begin to satisfy the same customer need.

Caused by technological advances.

Example:

- Media Industries:
  - Content going online.
  - Newspapers, magazines, TV, movies, radio, music.
  - Will print media become obsolete?

Strategic Groups

Strategic groups:

- A set of companies.
- Pursue a similar strategy.
- In the same industry.

The strategic group model (framework):

- Clusters different firms into groups.
- Is based on key strategic dimensions.

How to Create a Strategic Group Model

Identify the important strategic dimensions.

Choose two key dimensions:

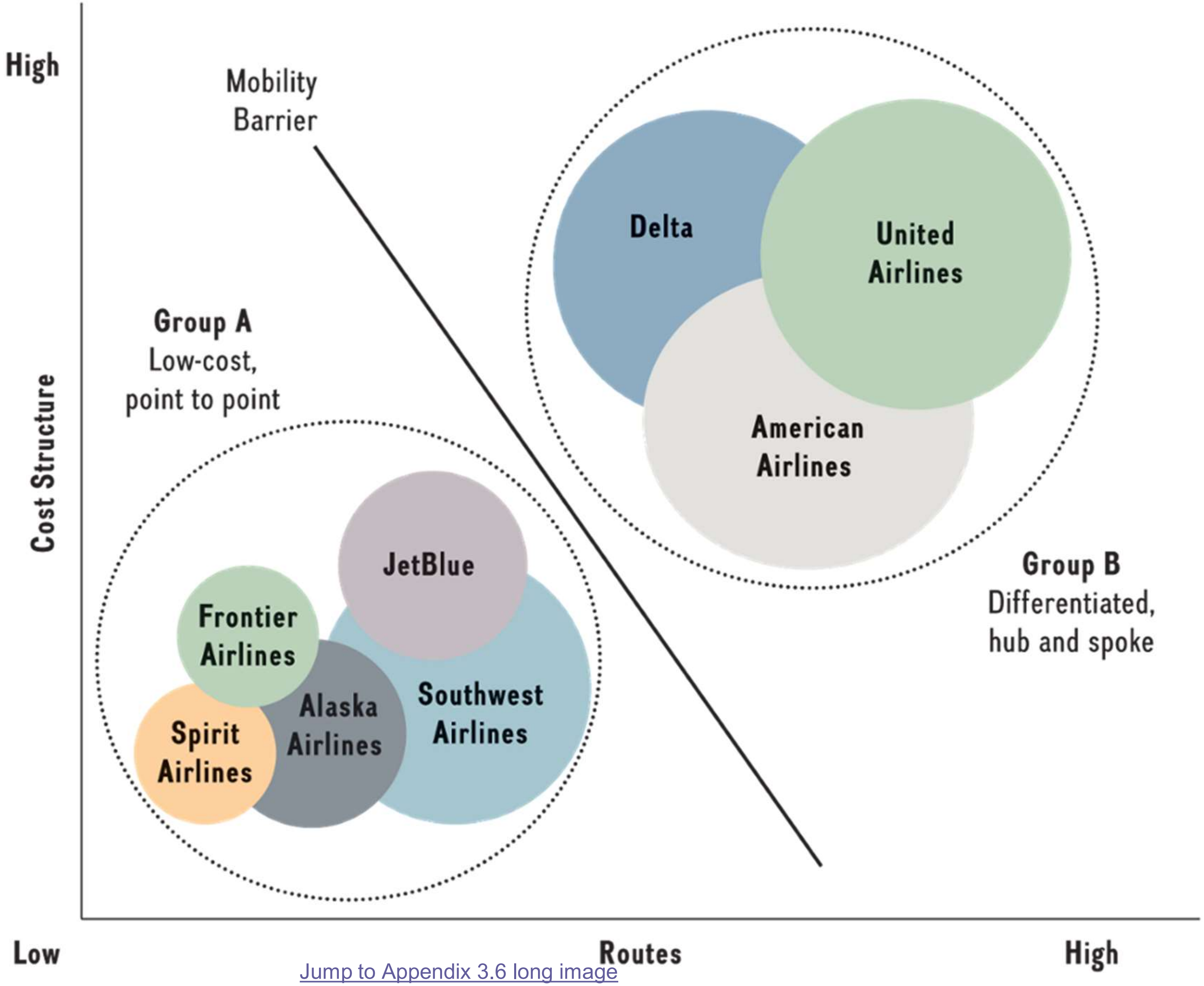
- For horizontal and vertical axes.
- Ensure they're not highly correlated.

Graph the firms in the strategic group.

- Each firm's market share indicated by the size of the bubble.

Strategic Groups and Mobility Barrier in U.S. Domestic Airline Industry

Exhibit 3.8



[Jump to Appendix 3.6 long image description]

Insights from Strategic Group Mapping

Competitive rivalry is strongest between firms in the same strategic group.

External environment affects strategic groups differently.

Five competitive forces affect strategic groups differently.

Some strategic groups more profitable than others.

Mobility Barriers

Restrict movement between strategic groups.

Industry-specific factors that separate one group from another.

Based on hard-to-reverse investments (strategic commitments).

End of Main Content

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Accessibility Content: Text Alternatives for Images

Industry Competitive Structures along the Continuum from Fragmented to Consolidated Text Alternative

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The most fragmented industry form is perfect competition and it is made up of many small firms. Firms are price takers, they offer commodity products, and there are low entry barriers. The next somewhat fragmented industry form is monopolistic competition, which consists of many firms with some pricing power; they offer a differentiated product and there are medium entry barriers. The next somewhat consolidated industry form is an oligopoly, which features few (large) firms, some pricing power, a differentiated product, and high entry barriers. The next consolidated industry form is a monopoly, which consists of one firm with considerable pricing power, a unique product, and very high entry barriers.

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Entry Choices Text Alternative

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This image is of a pentagon separated into five sides with a center block that reads "entry choices." The following words are inscribed in the blocks:

1. Who:
   - identify the players – incumbents, entrants, suppliers, customers, other stakeholders.
2. When:
   - entry timing, stage of industry life cycle, order of entry.
3. How:
   - leverage existing assets, reconfigure value chains, establish niches.
4. What:
   - type of entry – scale, commitment, product and / or service, business model, etc.
5. Where:
   - leverage existing assets, reconfigure value chains, establish niches.

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Strategic Groups and Mobility Barrier in U.S. Domestic Airline Industry Text Alternative

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The two strategic dimensions on the axes are prices and routes. As a result of this mapping, two strategic groups become apparent, as indicated by the dashed lines: Group A, low-cost, point-to-point airlines (Virgin Atlantic, Alaska Airlines, JetBlue, and Southwest Airlines) and Group B, differentiated airlines using a hub-and-spoke system (American, Delta, and United). The low-cost, point-to-point airlines are clustered in the lower-left corner because they tend to offer lower ticket prices but generally serve fewer routes due to their point-to-point operating system.

The differentiated airlines in Group B, offering full services using a hub-and-spoke route system, are clustered in the upper-right corner because their frequently higher ticket prices reflect frequently higher cost structures. They usually offer many more routes than the point-to-point low-cost carriers, made possible by use of the hub-and-spoke system, and thus offer many different destinations.

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