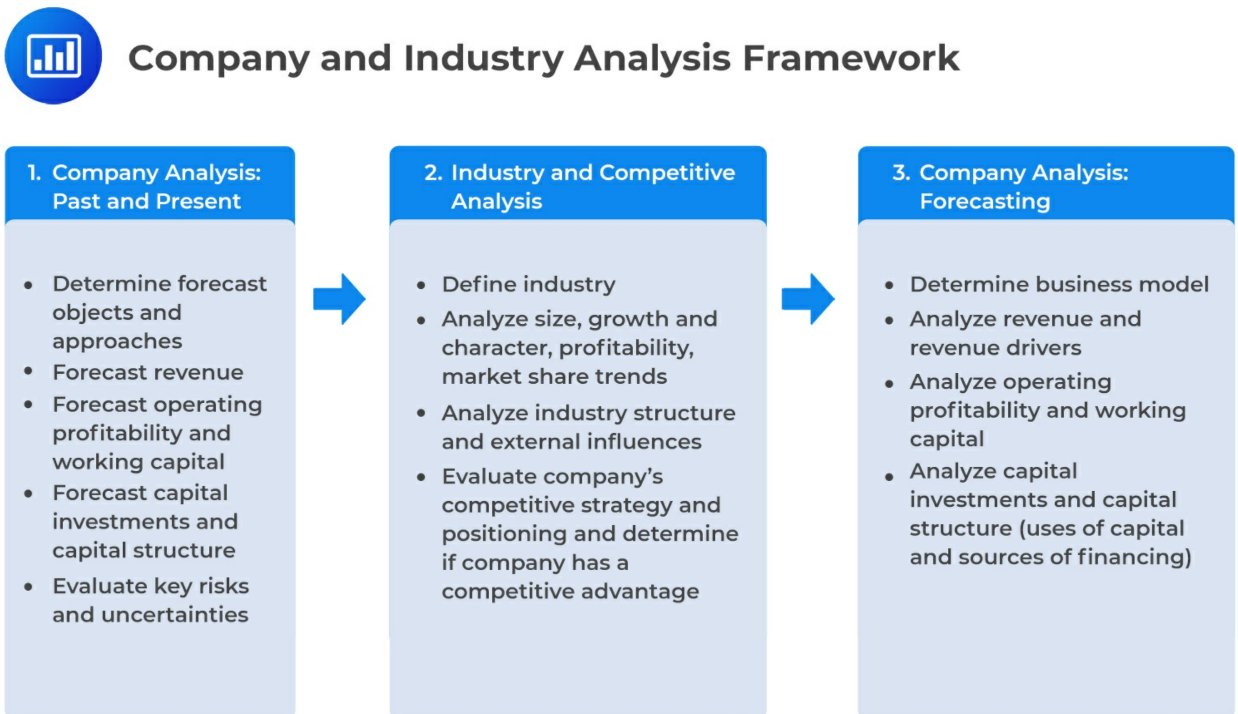
Learning Module 6: Industry and Competitive Analysis

LOS 6a: describe the purposes of, and steps involved in, industry and competitive analysis

Recall that industry and competitive analysis is the second step in the company and industry analysis framework:



Decoding Industry Dynamics and Profitability

Industries are ecosystems of interrelated businesses, often sharing fundamental operational characteristics. Companies within an industry usually possess parallel business models and face analogous market challenges. They not only vie for market share in product sectors but also in sourcing raw materials, talent, and other essential factors. This shared competitive environment exposes them to common demand trends, supply chain complexities, and overarching risks.

Porter's Five Forces model is a fundamental framework for grasping industry dynamics. It asserts that variations in profitability among industries stem from structural elements like the power of suppliers, the risk of new competitors entering the market, competitive intensity, the influence of buyers, and the potential for substitute products or services. While the broader industry context establishes a basic profitability course, factors specific to individual companies, such as innovative strategies, operational intricacies, company size, and management effectiveness, can lead to deviations from the industry average.

The Balancing Act: Industry Versus Company-specific Effects

The tug-of-war between industry and company-specific factors in shaping profitability has been the subject of extensive research. A seminal study by McGahan and Porter in 1997 highlighted this dynamic interplay. Their findings suggest that while the overarching industry environment is crucial in determining the sustainability of economic profits, the company-specific factors often wield a more potent influence, especially for companies that don't rank at the top of their industry. Essentially, while industry dynamics can act as a cap on profitability, they don't necessarily guarantee a minimum profitability threshold.

Competition as the Great Equalizer

In any industry, competition serves as a constant force, striving to push companies toward an industry's average profitability. The more intense the competition, the stronger this push. For analysts, understanding this dynamic is crucial. It allows them to gauge the industry's median profitability rate, anticipate possible structural shifts in the market, and determine where a specific company stands in relation to this established baseline. However, it's paramount to recognize the fluid nature of these dynamics. While the majority of businesses may hover around the industry average, outliers like disruptors or laggards can significantly deviate due to their strategies and market execution.

Importance of Analyzing an Industry

1. Improve Forecasts

A comprehensive understanding of an industry necessitates a deep dive into the various competitive forces at play. This includes not only direct industry competitors but also potential threats from alternative products, the influence and bargaining power of suppliers, and the ever-evolving demands and preferences of consumers. By adopting a bird's-eye view of the industry, analysts can demystify these dynamics. This typically involves meticulously documenting past competitive strategies, their implementation, subsequent market reactions, and the long-term outcomes of these strategic decisions.

An interesting revelation by Guan, Wong, and Zhang in 2014 showcased the nuanced layers of industry analysis. Their study found that analysts who broadened their horizons to include both companies and their suppliers in their evaluations showcased a markedly improved accuracy in predicting earnings.

2. Identify Investment Opportunities

Going beyond the obvious, conducting a thorough industry analysis can unveil hidden investment opportunities. Sometimes, an analyst may stumble upon a hidden gem – a company that industry giants previously overshadowed but, under closer scrutiny, demonstrates substantial strengths compared to its competitors. Additionally, for investors interested in the broader industry outlook rather than any particular company, the appeal might lie in the industry's overall growth prospects. These investors, seeking diversification, could opt for a 'basket approach,' spreading their investments across a range of companies in the industry. They can adjust their stakes based on factors like company size, market liquidity, or perceived future potential.

Industry and Competitive Analysis Steps

Industry and competitive analysis are vital tools for businesses and investors, offering a deeper understanding of a company's position within its industry and the competitive landscape. This analysis is generally approached in a structured manner, breaking down into specific steps to ensure a holistic understanding. Here are the key steps involved:

- **Define Industry**: Utilize third-party classification systems. Exercise judgment considering similar products, substitutes, multidivisional entities, and geographic locations.
- **Industry Survey**: Measure the industry's size, growth rate, character, profitability, and market share trends.
- **Industry Structure**: Conduct Porter's Five Forces analysis. Identify the most crucial elements and determine what needs continuous monitoring.
- **External Influences (PESTLE Analysis)**: Examine the Political, Economic, Social, Technological, Legal, and Environmental (PESTLE) influences on the industry.
- **Competitive Analysis**: Evaluate the company's competitive strategy within the industry context. Determine the competitive edge.

Question

Which of the following is most likely a primary implication of industry participants having parallel business models and competing in the same or similar product markets?

A. It results in identical profitability for all industry participants.
B. It ensures that all industry participants have the same competitive strategy.
C. It leads to the same demand and supply opportunities and risk factors for all industry participants.

The correct answer is **C**.

The key takeaway from the resemblance among industry players is that it results in identical demand and supply scenarios, along with shared risk factors for all participants in that industry. Typically, companies within an industry operate under comparable business models and vie for market share in the same or closely related product markets. Consequently, they encounter comparable structural elements that are prevalent in the industry, including the extent of competition, the negotiating strength of suppliers and customers, the possibility of new entrants into the market, and the potential for substitute products to emerge. These factors wield substantial influence over the opportunities and risks involving the demand and supply dynamics for all companies within that industry.

For example, if an industry is characterized by high competition, all companies in the industry may face pressure on prices and margins. Similarly, if an industry is dependent on a few large suppliers, all companies in the industry may face the risk of supply disruptions or price increases. Therefore, understanding the industry structure is crucial for assessing the opportunities and risks faced by companies in the industry.

A is incorrect. While industry participants may have similar business models and face similar industry structural factors, it does not necessarily result in identical profitability for all industry participants. Companies can differentiate themselves through various strategies, such as cost leadership, differentiation, or focus, which can lead to different levels of profitability. Furthermore, the profitability of a company also depends on its operational efficiency, financial management, and other company-specific factors.

C is incorrect. The similarity among industry participants does not ensure that all industry participants have the same competitive strategy. Even within the same industry, companies can adopt different competitive strategies based on their unique capabilities, resources, and market positioning. For example, some companies may choose to compete on price, while others may choose to compete on quality, innovation, or customer service. Therefore, the competitive strategy of a company is not solely determined by the industry structure but also by the company's own strategic choices.

LOS 6b: describe industry classification methods and compare methods by which companies can be grouped

An industry is generally defined as a collection of companies that offer similar products or services as perceived from a customer's perspective. For instance, Apple, Samsung, and Huawei can be grouped as they offer smartphones and related services. However, defining an industry can be complex due to several factors:

- Deciding whether to include substitute products or services. For example, should electric and traditional gasoline cars be classified in the same industry?
- Classifying companies that operate in more than one industry. For instance, Amazon operates in e-commerce, cloud computing, and entertainment sectors.
- Geographical considerations such as whether to classify companies based on their location or the markets they serve. For example, should a US-based company that primarily serves the European market be classified as a US company?
- Updating classifications as business models evolve over time. For instance, how should a traditional retail company transitioning to e-commerce be classified?

To help analysts navigate these challenges, third-party organizations maintain industry classification schemes. These schemes, such as the Global Industry Classification Standard (GICS), are widely used in investment management to categorize companies and facilitate industry analysis.

Early Classification Schemes (Legacy Schemes)

In the past, government agencies created early industry classification systems, like SIC (Standard Industrial Classification), NACE (Statistical Classification of Economic Activities in the European Community), and ISIC (International Standard Industrial Classification). These classification systems were tailored to individual countries and their specific needs.

These schemes grouped companies based on their production characteristics into industries such as agriculture, manufacturing, distribution, retail, and services. Moreover, these schemes were not updated frequently and became less useful with the emergence of new technologies and business models.

Modern Commercial Classification Schemes

Modern industry classification schemes such as the Global Industry Classification Standard (GICS), Industry Classification Benchmark (ICB), and The Refinitiv Business Classification (TRBC) are global and updated at least annually.

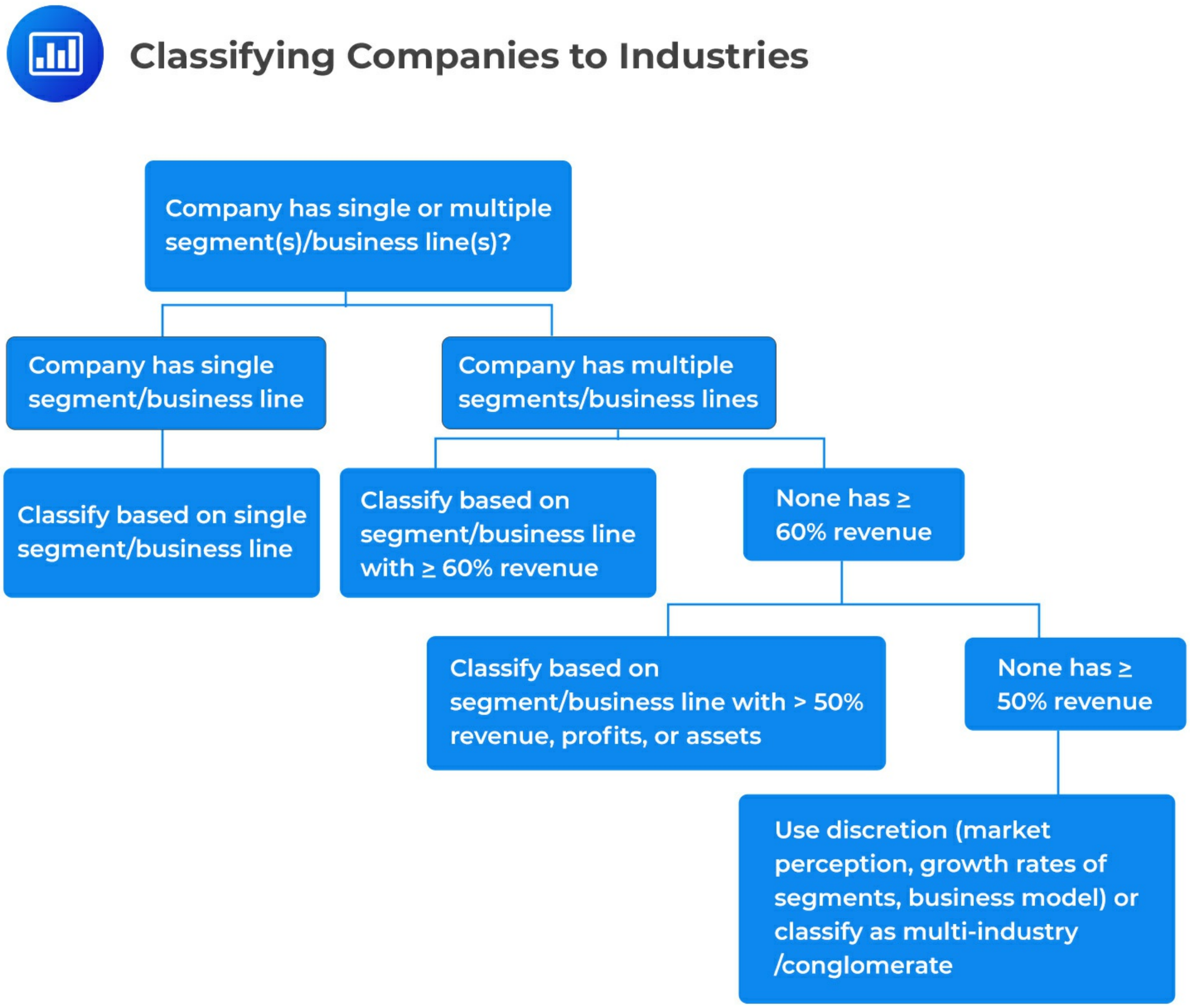
Unlike legacy schemes, which use a "supply" approach, these schemes group companies based on the similarity of the products or services they sell, a "demand" approach. For example, Netflix and Disney+ would be grouped as they offer streaming services.

GICS and ICB cover public companies, while TRBC covers private companies, non-profits, and government entities. Data aggregators (such as Bloomberg and FactSet) and stock exchange operators use these industry classification schemes or have their own substantially similar ones.

GICS, ICB, and TRBC are hierarchical taxonomies similar to the taxonomy used in biology. In other words, a company is placed in a single group in the lowest tier, where groups make up the higher tiers.

GICS, ICB, and TRBC each have distinct guidelines for classifying companies that operate across multiple industries, and all employ a certain degree of discretion. However, the process is similar, with the objective of classifying a company into a single grouping that describes most of its business.

The process is as follows:



GICS, ICB, and TRBC Structures

Global Industry Classification Standard (GICS)

GICS classification was jointly developed by Morgan Stanley Capital International (MSCI) and S&P Dow Jones Indices. These two financial institutions worked together to create this system.

1. Energy.
2. Financials.

3. Materials.
4. Information Technology.
5. Industrials.
6. Communication Services.
7. Consumer Discretionary.
8. Utilities.
9. Consumer Staples.
10. Real Estate.
11. Health care.

Industry Classification Benchmark (ICB)

ICB was developed by FTSE Russel. It consists of 11 industries, 20 supersectors, 45 sectors, and 173 sub-sectors. The ICB industries include:

1. Energy.
2. Financials.
3. Basic Materials.
4. Information Technology.
5. Industrials.
6. Telecommunications.
7. Consumer Discretionary.
8. Utilities.
9. Consumer Staples.
10. Real Estate.
11. Health care.

Refinitiv Business Classification (TRBC)

TRBC was developed by Refinitiv. It consists of 14 economic sectors, 33 business sectors, 154 industries, and 898 sub-sectors. The TRBC economic sectors include:

1. Energy.

2. Financials.
3. Basic Materials.
4. Technology.
5. Industrials.
6. Communication Services.
7. Consumer Cyclicals.
8. Utilities.
9. Consumer Non-Cyclicals.
10. Real Estate.
11. Healthcare.
12. Institutions, Associations, and Organizations.
13. Government Activity.
14. Academic and Educational Services.

Understanding the Limitations of Industry Classification Schemes

Third-party industry classification schemes are instrumental in conducting in-depth analyses in various domains, such as developing indexes and evaluating investment performances. However, analysts often face a myriad of challenges when leveraging these schemes for detailed industry research. In this document, we delve deeper into these obstacles and discuss their potential impact on industry analysis:

Classification Challenges

1. Classifying Companies with Business Model Variations or that Sell Substitute Products

Analysts frequently encounter challenges with third-party classification schemes that tend to categorize companies either in overly broad or excessively narrow groups, driven by their perception of product similarities and business models. For instance, if an analyst wants to delve into the intricacies of e-commerce platforms, they might consider the "technology" sector too inclusive. This sector combines companies like Shopify, which specializes in offering commerce platforms, and Check Point Software, which focuses on cybersecurity solutions. These two companies have distinct focuses and don't directly compete in the same market.

2. Grouping of Multi-product Companies

Since GICS, ICB, and TRBC are strict taxonomies, classification schemes tend to confine multi-product companies to a single category, which can complicate competitor analysis. A case in point is the cloud infrastructure sector, where an analyst might miss the competitive landscape between Microsoft's Azure and Amazon's AWS. Despite being formidable competitors in the cloud segment, their parent companies belong to different sectors, potentially leading to an oversight in competitive analysis.

3. Geographic Limitations in Classifications

The global scope of these classification schemes sometimes does not cater well to companies that have a significant presence on national or local scales. This issue arises mainly due to unique consumer behaviors or regulatory restrictions in different regions. For example, a healthcare provider operating predominantly in the UAE might find little merit in being compared with a global healthcare chain, given the stark differences in regulatory environments and consumer preferences in different regions.

4. Changes in Classifications over Time that affect Prior Period Comparability of Industry Statistics

Classification scheme providers may amend classifications over time, significantly impacting industry statistics. A prominent instance of this is the advent of the Real Estate sector, which primarily consists of Real Estate Investment Trusts. This shift caused a reclassification of companies from the Financial sector, considerably modifying the dynamics and performance indicators of both sectors.

Events in the market, like initial public offerings (IPOs) and de-listings due to acquisitions or bankruptcies, can alter the makeup of classification schemes. This can introduce survivorship bias when analyzing historical data. For example, if a company that consistently underperforms is removed from an index, it could artificially inflate the historical performance of that sector. This can lead to a distorted view of the industry's performance over time.

To ensure reliable and accurate analysis, analysts should focus on updating historical data to align with the latest classifications. Moreover, efforts should be directed toward creating datasets that are free from survivorship bias. This practice helps prevent the derivation of misleading conclusions based on outdated or distorted data, thereby fostering a more realistic and insightful analysis.

Alternative Methods of Grouping Companies

Grouping companies is not limited to industry or product approach. Other methods are used in contexts such as index construction and investment performance evaluation. These include:

- ### Geography:

Companies are classified by country, and then countries are aggregated into categories such as developed, emerging, and frontier markets. For example, a company might be classified as a US company if it is incorporated in the US, even if it primarily serves the Chinese market.

The classification of developed, emerging, and frontier markets is more controversial, and third parties like index providers use greater discretion. It is not a quantitative determination but considers variables such as the size and liquidity of equity securities markets in the country, income per capita, and legal restrictions on foreign investment.

- ### Sensitivity to the Business Cycle:

Companies are categorized as either "defensive" or "cyclical." Defensive companies are those whose sales growth, profitability, and valuations are less influenced by changes in broad macroeconomic factors like GDP growth. In contrast, cyclicals are more sensitive to these changes. For instance, a utility company is considered defensive because people need electricity regardless of the economy, whereas a luxury goods company is seen as cyclical. After all, its sales might decline during a recession.

This categorization is achieved by grouping entire sectors from industry classification schemes. It's possible to combine this approach with other methods, such as a geographic focus or credit ratings, to further refine exposure to specific risk factors.

- **Statistical Similarities:**

Companies are grouped based on similarities of financial ratios and market data or co-movements of their securities' investment returns. This approach includes grouping by size according to market capitalization or other characteristics such as valuation ratios, growth rates of sales or earnings, profitability ratios, and statistics based on price performance such as volatility and momentum. For example, small-cap growth companies might be grouped together based on their similar size and growth characteristics.

- **ESG Characteristics:**

Companies are grouped based on ESG (Environmental, Social, and Governance) characteristics, such as the ratio of carbon emissions to revenues, board and executive personnel diversity measures, and exposure to certain businesses such as tobacco and gambling. These metrics can be aggregated into composite ESG ratings or scores that enable cross-issuer comparability.

These groupings are usually relative and tend to show far more turnover in their constituents than groupings based on industries and countries because these statistics are less stable by company, and companies' rankings change. For example, a company might improve its ESG score by reducing its carbon emissions, moving it into a different grouping.

Question

Companies are often grouped based on ESG characteristics. Which of the following is *most likely* an example of an ESG characteristic?

A. The ratio of carbon emissions to revenues.
B. The ratio of sales to revenues.
C. The ratio of employees to revenues.

The correct answer is **A**.

The ratio of carbon emissions to revenues is an example of an ESG (Environmental, Social, and Governance) characteristic. ESG characteristics are factors that investors consider alongside traditional financial measures to gauge a company's performance and risk profile.

The environmental component of ESG refers to how a company's operations impact the natural environment. This includes factors such as a company's energy use, waste, pollution, natural resource conservation, and treatment of animals.

The ratio of carbon emissions to revenues is a measure of a company's environmental impact, specifically its carbon footprint, relative to its size. This ratio can be used to compare the environmental performance of companies within the same industry or across different industries. A lower ratio indicates a company that is more efficient in its use of resources and has a smaller environmental impact relative to its revenues.

B is incorrect. The ratio of sales to revenues is not an ESG characteristic. This ratio is typically equal to one, as sales are a component of revenues. It does not provide any information about a company's environmental, social, or governance practices.

C is incorrect. The ratio of employees to revenues is not typically considered an ESG characteristic. While it may provide some information about a company's efficiency or labor intensity, it does not directly relate to the company's environmental, social, or governance practices. However, other employee-related metrics, such as diversity and inclusion measures or worker safety statistics, could be considered ESG characteristics.

LOS 6c: determine an industry's size, growth characteristics, profitability, and market share trends

The process of industry and competitive analysis is a crucial part of understanding the business landscape. It begins with defining an industry, followed by a comprehensive survey to gather essential information for its evaluation. This survey involves several key steps, including estimating the industry size, calculating the historical growth rate, evaluating the character of the growth rate, measuring industry profitability, and identifying major industry players and market share trends.

Industry Size

The measurement of an industry's size is typically based on the cumulative annual sales figures observed from the product's or customer's perspective. It is critical to mention that the total sales might not encompass every sector of a company's sales. For example, in the case of a conglomerate like Amazon, only the revenues generated from its retail division would be accounted for when evaluating the retail industry size, excluding the contributions from other branches like Amazon Web Services.

An industry's expansion pace can be determined by analyzing the year-to-year rates annually or by calculating the compounded annual growth rate spanning multiple years. Additionally, a detailed assessment of the industry's growth can be conducted by segregating the contributions from volume increments and alterations in price or mix.

Approaches to Estimating Industry Size

The industry size estimation can be quite complex, especially for sectors not predominantly occupied by large public corporations, such as the automotive, smartphone, aviation, and pharmaceutical industries. In these cases, a significant portion of sales can be attributed to private firms, including smaller businesses, which might not have readily available data or be too cumbersome to accumulate.

To determine the size of industries, analysts use various methods. They can use economic indicators provided by government agencies, rely on surveys conducted by independent consulting firms, or study industry-specific data found in confidential resources disclosed during investor presentations by issuers. However, it's the analyst's responsibility to confirm the accuracy and credibility of these data points.

Industry Growth

The growth rate can be determined either through year-over-year rates annually or as a compounded annual growth rate spanning multiple years. Ideally, growth in the industry should be broken down by contributions from volume and price/mix factors.

Characterizing Industry Growth

The historical growth trajectory of an industry can be described by the intensity of its growth rate and its sensitivity to the business cycles.

One method of characterizing industry growth rate is a style box. This analysis involves comparing the historical growth rate of an industry against broader economic indicators during periods of economic downturns and booms. The analysis is significantly influenced by the growth rate magnitude and how the industry responds to economic cycles.

	Mature	Growth
Defensive	-Utilities -Beverages -Pharmaceuticals	-Biotechnology -Software -Gaming
Cyclical	-Crude oil -Natural gas -Freight transportation	-Semiconductors -Fintech -Digital advertising

Growth Industries

Growth industries are sectors that have not fully tapped into their potential market. Their growth trajectories are often independent of the general economic trends and are propelled by technological advancements or novel business models. Examples include the renewable energy sector and artificial intelligence (AI) industries.

Analysts scrutinizing growth industries focus on determining the sustainability of high growth rates and predicting the maximum market penetration level. These inquiries become particularly intricate with nascent industries. For instance, determining the peak market penetration for the electric vehicle industry can be complex, given its current growth phase.

Mature Industries

Mature industries are those that have exhausted their market growth potential, exhibiting growth rates that either mirror the general economic trends or are on a decline due to shifting consumer preferences. An example is the traditional print media industry, which is declining as digital media takes precedence.

Investors keen on mature industries are vigilant about potential disruptions, alterations in market competition, and the pace at which the industry is receding. For instance, investors in the cable television industry are constantly monitoring the rise of streaming services as a disruptive force.

Business Cycle Sensitivity

The business cycle sensitivity of an industry is predominantly determined by the business models of the companies within that industry and is often linked to the industry's maturity stage. Factors influencing this sensitivity encompass consumer dependency (discretionary or necessary) on the products or services, pricing strategies, interest rate impacts on the business model, and the nature of the product (durable goods versus recurring purchases).

Investors generally anticipate fluctuating returns from companies operating in cyclical industries. However, diverse perspectives regarding the duration and intensity of these cycles result in fluctuating valuations of companies over time. For instance, the real estate industry often experiences variations in valuations due to differing investor perceptions about market cycles.

The distinction between growth and mature companies can sometimes be of limited value. For instance, a significant economic downturn will likely negatively affect all companies, meaning differences emerge in magnitude rather than being purely categorical. Furthermore, within a given industry, firms at various life cycle stages can exhibit notable differences in growth, defensiveness, and cyclicality.

Analysis of Industry Profitability Measurement

One of the best approaches to gauge the profitability of an industry is by examining a time series distribution of returns on invested capital over a period of time. This analysis is grounded on evaluating after-tax operational profits against every dollar of capital invested, disregarding the influence of the capital structure. Nevertheless, implementing this strategy is often impracticable unless most companies in the industry are publicly listed.

To circumvent this obstacle, analysts frequently resort to evaluating the profitability of publicly listed companies, projecting a similar profitability trajectory for private firms within the industry. This projection can be realized by leveraging multiple data sources to infer the profitability metrics of private entities or by consulting data disseminated by government bodies or independent consultancies.

While aiming for a profitable industry is a rational approach, scrutinizing the chronological trends of profitability within the industry is often more insightful. This involves an in-depth analysis of the fluctuations in profitability over a span of time, identifying whether it is on an upward or downward trajectory. Detecting a significant trend in this analysis can serve as a pivotal focal point for analysts, guiding further investigative efforts.

Analysis of Market Shares and Industry Concentration

Market Share

Market shares are computed annually to gauge the influence and standing of different companies in an industry. This is done by determining the proportion of the total industry revenue that each company generates. Nevertheless, because determining the exact size of the industry can be challenging, it's advisable to view market shares as estimates within a certain range rather than pinpoint numbers.

Observing how a company's market share evolves over time can give us insights into how customers view the company's products in comparison to rival offerings. For example, a growing market share might indicate a positive customer response to a company's new line of eco-friendly products.

When analyzing market dynamics, it is essential to take note of acquisitions, especially substantial ones. Even though acquiring a rival can bolster a company's market share, it is vital to assess whether the company is expanding its market presence organically without relying on acquisitions. This paints a more accurate picture of a company's inherent growth and market acceptance. For instance, if a tech startup expands its market share by developing innovative products, it indicates organic growth.

Industry Concentration

It is crucial to factor in the concentration level within the industry. A lower concentration, characterized by the presence of many small competitors, is typically linked to intense competition unless the industry focuses on localized services or offers highly differentiated products. In contrast, increasing concentration, where few companies dominate the market, often results in reduced competition and increased profitability. For instance, a burgeoning industry like craft breweries, characterized by numerous small players, usually experiences high competitive intensity.

Herfindahl-Hirschman Index (HHI)

A widely used tool to assess industry concentration is the Herfindahl-Hirschman Index (HHI), which is derived by summing up the squares of the market shares of all industry participants. As such, the Herfindahl-Hirschman Index (HHI) is calculated as follows:

$$\text{HHI} = \sum_{i=1}^{n} s_i^2$$

where: s_i stands for the market share of the ith company, represented as a whole number (for example, a market share of 40% is denoted as 40, rather than 0.40).

To illustrate, an industry dominated by four firms with market shares of 40%, 30%, 20%, and 10% would have an HHI of $40^2 + 30^2 + 20^2 + 10^2 = 3000$. In the extreme case of a monopoly, the HHI would reach the maximum value of 10,000 ($= 100^2$).

Antitrust agencies in various nations deem markets with an HHI between 1500 and 2500 moderately concentrated and those with an HHI above 2500 highly concentrated. As a rule of thumb, if an acquisition in a highly concentrated market increases the HHI by over 200 points, it might face regulatory hurdles, as it could potentially lessen competition further.

Question

Which of the following are *most likely* the key issues for investors in a mature industry?

A. Identifying major industry players and analyzing market share trends.
B. Estimating the size of the industry and calculating its historical growth rate.
C. Monitoring for disruptive threats, changes in competitive intensity, and the speed of decline.

The correct answer is **C.**

Investors in mature industries face several important challenges. These include keeping an eye out for disruptive threats, shifts in competitive intensity, and the pace of decline. Mature industries typically experience slow growth, have established competitors, and predictable market dynamics. Yet, they can also be vulnerable to disruptions from new technologies or business models. Changes in competitive intensity might occur due to shifts in market share or strategies among competitors. The speed at which the industry declines can also be a concern as it moves toward obsolescence. Investors must diligently monitor these factors as they can have a substantial impact on the profitability and sustainability of companies within the industry.

In mature industries, there are key challenges to consider. Disruptive threats can jeopardize established business models, shifts in competitive intensity may put pressure on profit margins, and a rapid decline can lead to stranded assets. Consequently, having a deep understanding of these dynamics is essential when making investment decisions in such industries.

A is incorrect. Identifying major industry players and analyzing market share trends are also important aspects of industry analysis. However, they are not the key issues for investors in a mature industry. In a mature industry, the major players and market share trends are usually well-established and do not change significantly over time. Therefore, while understanding these factors can provide insights into the competitive landscape, they are not the primary concerns for investors in a mature industry.

B is incorrect. While estimating the size of the industry and calculating its historical growth rate are important aspects of industry analysis, they are not the key issues for investors in a mature industry. The size and growth rate of the industry are more relevant for investors in growth industries where the potential for expansion is a key driver of investment returns. In a mature industry, the focus is more on the competitive dynamics and the risks of disruption or decline.

LOS 6d: analyze an industry’s structure and external influences using Porter’s Five Forces and PESTLE frameworks

Understanding Porter's Five Forces Analysis

Porter's Five Forces is a vital analytical tool used to scrutinize the structure of an industry, which subsequently aids in predicting the potential long-term profitability of the industry, gauged through the returns on invested capital. The magnitude of the five pivotal forces in an industry greatly influences its profitability prospects.

Intense forces imply subdued profitability for companies within the industry, while milder forces suggest a potentially lucrative industry.

While historical data from industry surveys may have offered insights into the industry's past profitability, analyzing the structural forces transcends mere profitability measurement. It encompasses a qualitative evaluation of the profitability drivers and enhances awareness of critical factors that could influence industry profitability in the future. This method proves particularly beneficial in nascent industries where data might be scarce or in industries that are yet to reach a profitable stage, helping to anticipate potential profitability trajectories.

The critical forces to be evaluated are as follows:

Analyzing Porter's Five Forces

Examining the five forces is akin to analyzing a company's business model, characterized by qualitative research that resists generalization. More specifically, we will employ a checklist approach, which involves a set of questions in each respective force.

1. Threat of New Entrants

Analysis in this segment involves evaluating the probable threats that new industry entrants might pose. It involves answering the following questions:

- Has there been a notable influx of new entrants in the industry in recent times?

- Are there network effects in the industry, where the value of the product or service increases as more people use it, potentially causing a new entrant to have a less valuable offering until it achieves a larger user base?
- Do established players gain advantages from economies of scale due to substantial fixed costs, implying that a newcomer might need considerable time and face unprofitable conditions before achieving competitiveness?
- Do existing companies gain advantages from economies of scope spanning various business segments–resulting from heightened customer convenience and market dominance and/or from shared costs that can be optimized across their operations?
- Do consumers exhibit brand loyalty?
- Do customers face considerable switching costs in terms of time, education, or substitution?
- Do established players possess unique or favored access to scarce resources or direct customer touchpoints?
- Do government regulations impose limitations or delays on entering the industry?

2. Threat of Substitutes

This analysis entails examining the threats presented by alternative products or services:

- Is there an alternative product or service that meets the same or similar customer requirements? Is its cost lower?
- Can consumers manage without the product offered by the industry?
- Is the alternative product's performance getting better compared to the product of the industry?
- Is the transition to an alternative challenging for consumers?

3. Bargaining Power of Customers

Here, the focus is on evaluating the negotiating strength of customers or buyers in the industry:

- Does a small number of dominant customers characterize the industry?
- Is the industry's products standardized or undifferentiated?
- Do the customers deem the industry's products as essential?
- Do the industry's products constitute a significant portion of the customers' budget?
- Can customers opt for backward integration, meaning they choose to "produce" instead of "purchase" what the industry offers?

4. Bargaining Power of Suppliers

This segment involves evaluating the negotiating power of suppliers:

- Does a small number of dominant suppliers characterize the industry?
- Are there considerable costs associated with changing suppliers?
- What are the switching costs for companies to change suppliers?
- Are the suppliers distinct or specialized in their offerings?
- Are there alternative products available that can replace those provided by the suppliers?

5. Rivalry among Existing Competitors

This analysis examines the extent of competition or rivalry among the existing players in the industry. For instance, the fast-food industry is marked by intense competition with numerous established players:

- Has there been a history of price rivalry among competitors?
- Do multiple competitors of similar size exist in the market?

- Are the products differentiated?
- Are there significant obstacles to leaving the industry?
- Is the growth rate of the industry sluggish?

External Influences on Industry Growth

The external influence on industry growth is done using the PESTLE analysis framework. It involves the assessment of political, economic, social, technological, legal, and environmental impacts on an industry.

Political Influences on Various Sectors

Political influence influences involve changes in fiscal and monetary policies, the government's direct interventions in markets, regulatory shifts, and geopolitical developments. Political impacts are significant in the following sectors: energy, healthcare, and defense:

Energy Sector

The energy sector is affected by three main political influences: short-term political desire for stable and low energy prices, climate accords and laws advocating for reduced emissions, and the activities of OPEC (Organization of the Petroleum Exporting Countries).

Short-term political interest in maintaining low energy prices to appeal to consumers and businesses with inelastic price demand. On the other hand, long-term strategies may focus on higher prices to curb demand and meet emission targets. Investors and producers might be concerned about the long-term perspective, given that governments plan to reduce the proportion of fossil fuels in the energy mix. However, cutting down on fossil fuel production conflicts with the desire for low energy prices in the short run.

The actions of OPEC, which controlled 35% of global crude oil production in 2021, significantly influence global energy prices, possibly maintaining low prices to slow the transition to renewables. For instance, OPEC members might opt to maintain prices at a level that hinders the shift to renewables, capitalizing on governments' short-term requirements for low energy prices.

Healthcare Sector

Governments are the primary purchasers of healthcare products and services, sometimes implementing reforms to gain political favor or address fiscal issues. For instance, governments have undertaken reforms, including extending healthcare coverage and subsidies, implementing price controls or reductions, and limiting specific healthcare services or products.

Defense Sector

Defense spending is dictated by geopolitical objectives, perceived threats, and alliance commitments. From the late 1990s to 2010, a notable increase in global military spending as a share of global GDP benefited defense companies. Moreover, geopolitical events and competing budgetary priorities will determine future defense expenditures.

Nations are selective regarding the countries they allow their domestic defense companies to engage with. The contracting procedure is complex, encompassing third-party expenses and performance evaluations.

Economic Influences on an Industry

Various economic indicators, including fluctuations in GDP, personal income, inflation, interest rates, and exchange rates, play a pivotal role in shaping industries. Some of these influences are cyclical, moving in tandem with the business cycle. Others are structural, arising from enduring demographic shifts or productivity growth rates in various nations.

Specific sectors like financial services and consumer discretionary goods are particularly sensitive to these cyclical economic shifts. For example, during economic recessions, discretionary spending has a noticeable contraction, which can significantly impact the luxury goods sector.

Managing exchange rate fluctuations becomes paramount to safeguard profitability for industries operating in multiple currency zones. This is especially crucial when there's a significant mismatch between the currency composition of revenues and costs or when operating in countries known for currency instability. To navigate such challenges, companies often turn to strategies like hedging.

With faster growth, multinational corporations frequently set their sights on emerging markets. A case in point: Nestlé SA, which in 2022, derived over 40% of its sales from emerging markets, registered faster volume growth there compared to its performance in developed markets.

The automotive industry, selling high-priced durable goods, experiences significant influences from economic factors. In economic downtimes, consumers may delay buying new vehicles, opting for used cars, or retaining their current vehicles.

Social Influences on Industries

Social influences on an industry cover cultural and consumer trends, demographic changes such as relative population growth rates, and lifestyle changes.

Social influences are pivotal in shaping industries, particularly those directly interacting with consumers. These influences foster a dynamic relationship between companies and society, characterized by mutual influence and changing trends.

While these influences appear external, they're intricately linked with industry actions. Companies shape cultural narratives through avenues like political lobbying, advertising, and strategies like product media placements. Additionally, the rising prominence of social media and journalism has magnified reputational risks for businesses. There's mounting pressure to ensure sustainable sourcing and a heightened examination of supply chains for potential human rights infringements.

Social influences are particularly amplified in industries that target direct consumers. For instance, together with technological and economic influences, the global beauty industry, especially the premium segment, has seen robust growth since 2010. Moreover, the advent of superior camera quality in mobile devices, coupled with social media, has amplified the significance of personal aesthetics. Furthermore, these platforms have enabled beauty brands to market through third-party influencers and video demonstrations effectively.

Creation of a dynamic ecosystem where companies and society mutually influence each other.

Technological Influences on Industries

Technological advancements significantly influence industries by either fostering new developments or rendering existing products obsolete. These advancements can be categorized into sustaining and disruptive innovations, which have varying impacts on the market dynamics and industry leaders.

Sustaining Innovations

Sustaining innovations refers to incremental improvements in products or services without altering core functionalities or operations. They are typically led by established industry players (incumbents) aiming to better cater to existing or adjacent customers.

An example of sustaining innovation is progressive enhancements in cable television technology, including digital transmission, improved video quality, and increased channel offerings.

Disruptive Innovations

Disruptive innovations introduce new markets or reshape existing ones with radically different value propositions that, initially, might not appeal to existing customers but gradually gain traction. For instance, the rise of internet-based video streaming services disrupted the traditional cable television industry.

With the rise of disruptive innovations, the incumbent companies face a dilemma in adopting disruptive innovations (innovator's dilemma). They will choose to Adopt disruptive innovations, which might accelerate the decline of existing businesses but can prevent market share loss. Alternatively, the incumbents may choose to Ignore the disruptive innovations, which can maintain short to medium-term profits but risk market share loss in the long run.

Legal Influences on an Industry

Legal influences pertain to the modifications in laws and regulations that could modify the operational practices or economic outcomes of industries. These changes often represent adjustments to existing regulations that oversee the industry's functioning. Companies usually try to mold these legal influences through policy advocacy and legal actions.

Two industries where legal influences have a pronounced impact are the tobacco and cannabis sectors:

Tobacco Industry

Jurisdictions globally have implemented diverse laws and regulations governing the entire spectrum of tobacco-related activities. These rules aim to deter consumption and mitigate the detrimental health effects linked to tobacco, including the risks of secondhand smoke. Regulatory aspects cover a vast area, from advertising restrictions, mandatory graphic warnings on packaging, and age-specific sales limits to more comprehensive bans on public smoking and restrictions on nicotine content and flavor additives. Besides these specific regulations, the sector is also subjected to considerable taxation.

Cannabis Industry

The cannabis industry's legal framework is in a state of flux. Various jurisdictions stand at different points on the legalization spectrum. For instance, Canada has legalized cannabis production, sales, and consumption. In contrast, nations like the USA exhibit a more fragmented approach, with individual states dictating their distinct cannabis policies. Yet, in most Asian and African countries, cannabis remains completely illegal.

Environmental Influences on Industries

Environmental influences are primarily aligned with legal influences, encompassing the challenges and prospects that arise with the shift towards a greener economy. These influences include aspects such as carbon emission reductions, waste and land management, and environmental conservation.

Due to environmental influences, companies may need to adapt business operations due to regulatory shifts, taxation, and consumer preferences. Failure to adapt might lead to losing market share to greener alternatives.

Question

Which of the following is *most likely* the difference/similarity between sustaining and disruptive innovations in the context of technological changes?

A. Both sustaining and disruptive innovations refer to improvements in product or service performance.
B. Sustaining innovations create a new market or enter an existing one with a different value proposition, while disruptive innovations refer to improvements in product or service performance.
C. Sustaining innovations refer to improvements in product or service performance, while disruptive innovations create a new market or enter an existing one with a different value proposition.

The correct answer is **C**.

Sustaining innovations refer to improvements in product or service performance, while disruptive innovations create a new market or enter an existing one with a different value proposition. Sustaining innovations are typically incremental improvements or advancements in technology that help a company maintain or strengthen its position in the market.

They are often targeted at a company's existing customers and are designed to meet their expected needs. On the other hand, disruptive innovations are not just improvements or advancements. They create a new market and value network, or they disrupt an existing market and value network by introducing simplicity, convenience, accessibility, and affordability.

Disruptive innovations are typically produced by outsiders and entrepreneurs rather than existing market-leading companies. The term 'disruptive innovation' was defined and analyzed by the American scholar Clayton M. Christensen and his collaborators beginning in 1995.

A is incorrect. This choice incorrectly states that both sustaining and disruptive innovations refer to improvements in product or service performance. While it is true that sustaining innovations refer to such improvements, disruptive innovations are characterized by creating a new market or disrupting an existing one with a different value proposition, not merely by improving product or service performance.

B is incorrect. This choice incorrectly swaps the definitions of sustaining and disruptive innovations. As explained above, sustaining innovations refer to improvements in product or service performance, while disruptive innovations create a new market or enter an existing one with a different value proposition.

LOS 6e: evaluate the competitive strategy and position of a company

Understanding the competitive strategy and position of a company is crucial for analysts and investors because it provides insights into the company's approach to gaining a competitive edge in the market and its ability to create value for its stakeholders.

Understanding Competitive Strategy

Every company, whether a multinational corporation like Apple or a local bakery, has a competitive strategy. This strategy can be either intentional or unintentional—an intentional strategy results from company-wide planning, performance measurement, and feedback loops to refine the strategy. For instance, Apple's intentional strategy might involve continuous innovation and high-quality product design.

On the other hand, an unintentional strategy arises from different teams within a company pursuing their incentives, repeating past actions, or adhering to industry or professional norms. For example, a bakery might unintentionally develop a strategy of baking more bread on weekends due to higher demand without any formal planning.

Unintentional strategies often exacerbate communication and coordination issues within a company, although they might perform well in areas like discovery-oriented research. The effectiveness of a competitive strategy is demonstrated by a company's history of value addition for its stakeholders, such as economic profits. The effectiveness of a strategy can only be judged retrospectively.

Evaluating Competitive Strategy

To evaluate a competitive strategy on a forward-looking basis, an analyst should assess the strategy along the following three dimensions:

- Does the strategy create a defense against the five industry forces? For example, does Apple's strategy of continuous innovation and high-quality design protect it from competitive rivalry, threat of new entrants, threat of substitutes, bargaining power of suppliers, and bargaining power of customers?

- Does the strategy benefit from, or is at least not at odds with, the expected external industry influences identified in the PESTLE analysis? For instance, does a bakery's strategy align with the political, economic, social, technological, legal, and environmental factors affecting the bakery industry?
- Does the company have the resources and capabilities to execute the strategy? For example, does Apple have the necessary technological expertise, financial resources, and human capital to execute its strategy of continuous innovation and high-quality design?

The analysis and answers to these questions are specific to each company and industry.

Three Well-Known Competitive Strategies

Three prominent competitive strategies that have been demonstrated to be successful across a myriad of industries are cost leadership, differentiation, and focus. These strategies, outlined in Michael Porter's seminal research on business competition, offer distinct pathways to achieving a competitive edge.

Cost Leadership:

Cost leadership, as exemplified by companies like Walmart, hinges on minimizing costs and offering products at prices lower than competitors. It is executed through means such as achieving economies of scale, fostering a culture of strict cost control, and establishing low-cost distribution channels. This approach effectively shields against the threats of new entrants and intense industry rivalry, making it particularly suitable in industries where price is a major determinant of customer choice. However, it does carry risks, such as potential cost inflation and technological changes, that can erode the cost leadership position.

Differentiation:

Pursued by companies like Apple, differentiation strategy revolves around offering products with unique features and superior quality. It entails a substantial investment in advertising, brand building, and customer service. The goal is to create customer loyalty and reduce the bargaining power of buyers, thus defending against new entrants and substitutes. This strategy is often appropriate in industries characterized by innovation and where customers value distinctiveness. Yet, it is not without risks, including imitation by competitors and a potential increase in the pricing premium, which might deter customers.

Focus:

Focus strategy is often adopted by niche players, like a local bakery specializing in a specific type of bread, which focuses on serving a narrow target market exceptionally well. Leveraging a deep understanding of customer needs and preferences, companies adopting this strategy often incorporate elements from both cost leadership and differentiation strategies but with a more narrowed focus.

Focus strategy works effectively to defend against the threat of new entrants and substitutes, especially in sectors where customers are not primarily driven by price and have a preference for premium products. However, it risks being outcompeted in price and changing customer preferences. As outlined in the CFA curriculum, vol 3, page 520, the following is the analysis of the three strategies:

Strategy Aspects	Cost Leadership	Differentiation	Focus
Executing strategy means	−Economies of scale from fixed costs −Favorable access to raw materials −Culture of strict cost control −Aggressive pricing to gain high volume −Low-cost distribution −Economies of scope	−Investments in advertising, brand, customer service −Superior quality, unique features −Culture of strong customer experience −Premium pricing −Integration of services, software, and hardware	−Proximity to customers, strong understanding of −Protection using trademarks, copyrights, patents −Incorporate elements of both strategies, focus on a particular group
Which of the Five Forces it defends against	−Threat of new entrants: Capital requirements, scale advantages −Bargaining power of customers: Customers can only bring prices down leaving margin for cost leaders −Industry rivalry: Rivals may not compete on price	−Threat of new entrants and of substitutes: Customer loyalty deters switching, protect market share −Bargaining power of customers: Customers unwilling to comparison shop −Bargaining power of suppliers: Pass price increases to customers	−Threat of new entrants and of substitutes: Customer loyalty deters switching, protect market share −Bargaining power of customers: Customers unwilling to comparison shop −Difficult to serve particular customer group
Industry appropriateness	−Price-conscious customers −Minimal innovation in industry	−Customers value distinctiveness −Innovation varies in features	−Price not foremost concern −Desire for premiumization
Risks to the strategy	−Capital intensive −Cost inflation, loss of discipline −Technological change results in loss	−Imitation by competitors −Pricing premium too high −Buyers no longer demand service	−Larger competitors outcompete on price −Differences in demand narrow −May preclude high market share −Buyers no longer demand service

Question

Which of the following statements about the competitive strategies outlined by Michael Porter is *most accurate?*

A. Cost leadership strategy is suitable for companies that prioritize creating products with unique features and superior quality.
B. Differentiation strategy aims to defend against the threat of new entrants and substitutes primarily by achieving economies of scale.
C. Focus strategy is often adopted by niche players targeting a narrow market segment and may incorporate elements from both cost leadership and differentiation strategies.

The correct answer is **C.**

The focus strategy is about serving a narrow or specific segment of the market exceptionally well, often by understanding their unique needs and preferences deeply. As described, this strategy can take elements from both cost leadership (e.g., serving this niche at a low cost) and differentiation (e.g., offering the niche a unique product).

A is incorrect. Cost leadership emphasizes minimizing costs to offer products at lower prices than competitors. It does not prioritize the creation of products with unique features and superior quality; that's the essence of the differentiation strategy.

B is incorrect. While the differentiation strategy indeed defends against the threat of new entrants and substitutes, it does so by offering unique and high-quality products, fostering customer loyalty, and reducing the bargaining power of buyers. Achieving economies of scale is primarily an element of the cost leadership strategy, not differentiation.