

Analyzing Industry Structure



By Laurent EBERHA from L'Union, France [CC BY-SA 2.0 (<http://creativecommons.org/licenses/by-sa/2.0/>), via Wikimedia Commons]

The Fundamental Principle of Business Strategy

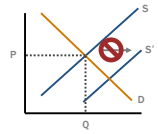
"If everyone can do it, it's difficult to create and capture value from it."

or, alternatively

"In a perfectly competitive market, no firm realizes economic profits (rents)."

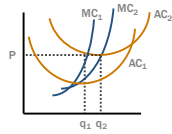
Two Perspectives on Rents

Monopoly Rents
(Industrial Organization View)



- Barriers to entry
- Industry structure matters

Ricardian Rents
(Resource Based View)

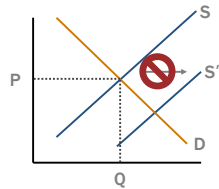


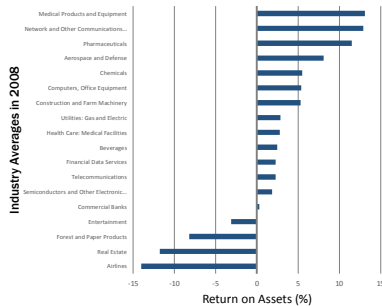
- Barriers to imitation
- Firm structure matters

The Role of Industry Structure

• The Industrial Organization Perspective:

- Premise that industry structure matters most
- Economic rents due to barriers to competition (i.e., monopoly rents)
- Some industries are more profitable than others





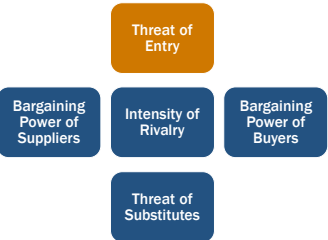
Source: Fortune 500 2009, money.cn.com

The Strategist’s Toolkit:
Five Forces Analysis



Threat of Entry, Part 1

The Strategist’s Toolkit:
Five Forces Analysis



Threat of Entry

- Entry is **less** likely when...
 - Entrant faces high sunk costs
 - Sunk costs are investments that cannot be recovered
 - Incumbents have a competitive advantage
 - Potential entrants are at a competitive disadvantage compared to existing players, simply not profitable to enter
 - Entrant faces retaliation
 - Potential entrants are likely to be forced out of business by strategic (pricing) behavior of incumbents

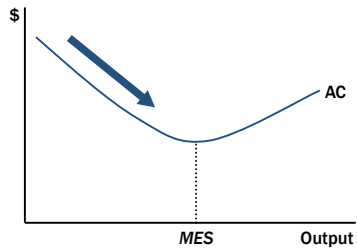
Threat of Entry

- Entry is **less** likely when...
 - Entrant faces high sunk costs
 - Sunk costs are investments that cannot be recovered
 - Incumbents have a competitive advantage
 - Potential entrants are at a competitive disadvantage compared to existing players, simply not profitable to enter
 - Entrant faces retaliation
 - Potential entrants are likely to be forced out of business by strategic (pricing) behavior of incumbents

Competitive Advantages

- Patents & licenses
- Pioneering brands
- Pre-commitment contracts (e.g., distribution)
- Large economies of scale (relative to demand)
- Steep learning (experience) curves
- Others

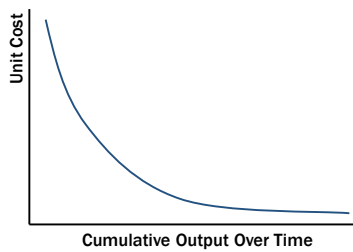
Economies of Scale



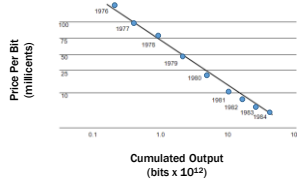
Competitive Advantages

- Patents & licenses
- Pioneering brands
- Pre-commitment contracts (e.g., distribution)
- Large economies of scale (relative to demand)
- Steep learning (experience) curves
- Others

Learning Curves



Learning Curve for Semiconductor Memories



Threat of Entry, Part 2

Threat of Entry

- Entry is **less** likely when...
 - Entrant faces high sunk costs
 - Sunk costs are investments that cannot be recovered
 - Incumbents have a competitive advantage
 - Potential entrants are at a competitive disadvantage compared to existing players, simply not profitable to enter
 - Entrant faces retaliation
 - Potential entrants are likely to be forced out of business by strategic (pricing) behavior of incumbents

Likelihood of Retaliation

- Excess capacity of incumbents
- Economies of scale or other cost advantage
- Substantial *exit* costs
 - Exit costs are payments that must be made upon exit
 - Exit costs provide an incentive to fight
- Aggressive reputation of incumbents
 - Must be credible
 - Suffers from free-riding problem

Threat of Substitutes

The Strategist's Toolkit: Five Forces Analysis

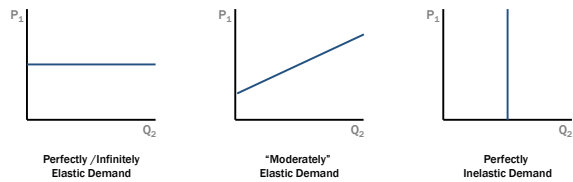


Threat of Substitutes

- Substitute products are **less** of a threat when...
 - Cross-price elasticity of demand is low
 - Switching costs are high
 - One-time costs customers incur when switching to a new product or service

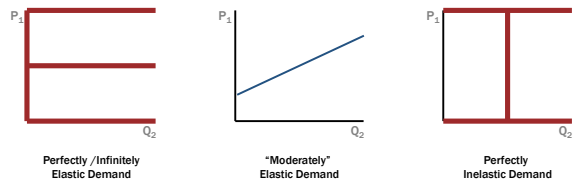
Cross-Price Elasticity

The ratio of the % change in demand for one good given a 1% increase in price of another good.



Cross-Price Elasticity

The ratio of the % change in demand for one good given a 1% increase in price of another good.



Threat of Substitutes

- Substitute products are **less** of a threat when...
 - Cross-price elasticity of demand is low
 - Switching costs are high
 - One-time costs customers incur when switching to a new product or service

Bargaining Power of Buyers, Part 1

The Strategist's Toolkit: Five Forces Analysis



Bargaining Power of Buyers

- Buyers have **less** power when...
 - Buyers are not concentrated (no monopsony)
 - Many potential buyers
 - Each accounts for a small fraction of sales

Relative Concentration

Buyer	Many	Monopoly Power	Competitive
	Few	Mutual Dependence	Monopsony Power
		Few	Many
		Supplier	

Bargaining Power of Buyers

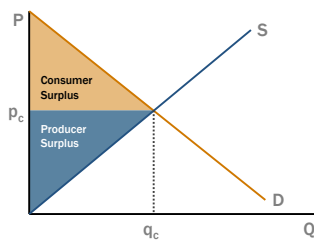
- Buyers have **less** power when...
 - Buyers have few options
 - Products are differentiated (low intra-industry CPE)
 - High switching costs (relationship-specific assets)
 - Buyer cannot backward integrate

Bargaining Power of Buyers, Part 2

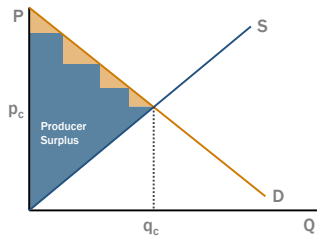
Bargaining Power of Buyers

- Buyers have **less** power when...
 - Buyers are not concentrated
 - Buyers have few options
 - Buyers are segmented
 - Price information is not widely available
 - Price discrimination possible
 - Bundling possible

Price Discrimination



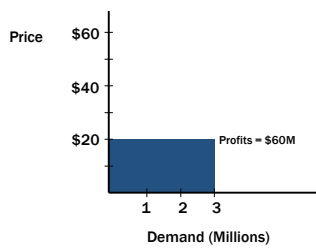
Price Discrimination



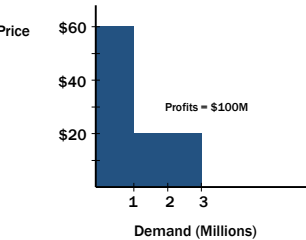
Self-Sorting 2nd Degree Price Discrimination



Self-Sorting 2nd Degree Price Discrimination



Self-Sorting
2nd Degree Price Discrimination

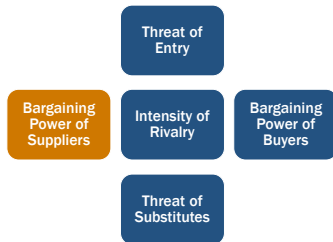


Sorting by Groups
3rd Degree Price Discrimination

Willingness to Pay for Product					
Consumer Type	A	B	C	D	Type Total
HR	\$100	\$90	\$70	\$20	\$280
Engineers	\$60	\$120	\$70	\$70	\$290
Sales	\$100	\$80	\$140	\$60	\$380
Consultants	\$70	\$100	\$60	\$80	\$310
Min. Willingness to Pay for Product	\$60	\$80	\$60	\$20	\$220

Bargaining Power of
Suppliers

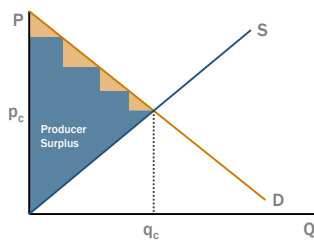
The Strategist's Toolkit: Five Forces Analysis



Bargaining Power of Suppliers

- Suppliers are **less** of a threat when...
 - Sellers are not concentrated (no monopoly)
 - Firms have many alternatives
 - Many substitutes for supplier's products
 - Firms face low switching costs
 - Supplier cannot forward integrate
 - Sellers may not treat segments differently
 - Price information is widely available
 - Price discrimination not possible

Price Discrimination



Intensity of Rivalry

The Strategist's Toolkit: Five Forces Analysis



Intensity of Rivalry

- Rivalry is **less** intense when...
 - The number of competitors is...?

Intensity of Rivalry

- Rivalry is **less** intense when...
 - The number of competitors is **small!**

Intensity of Rivalry

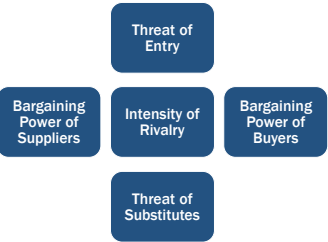
- Rivalry is **less** intense when...
 - The number of competitors is small!
 - Incentives to "fight" are low
 - Substantial market growth
 - Especially if capacity constrained
 - Opportunities to differentiate
 - Low exit costs
 - Little excess capacity
 - Demand is not cyclical

Intensity of Rivalry

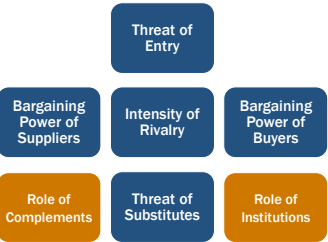
- Rivalry is **less** intense when...
 - Coordination is feasible
 - Explicit price / market fixing
 - Antitrust violation!
 - Tacit coordination
 - Implicitly holding prices high, differentiating

Module Lessons

The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis



Module Lessons

- A key task in a strategic analysis is to identify and address the competitive forces that limit economic rents:
 - Entry is less likely when incumbent firms have a competitive advantage and can credibly retaliate against new entrants.
 - Substitution is less likely when switching costs are high and cross-price elasticity is low.

Module Lessons

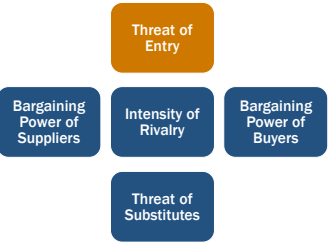
- A key task in a strategic analysis is to identify and address the competitive forces that limit economic rents:
 - Buyer and supplier power depend on relative concentration, the viability of alternatives, and information availability.
 - Rivalry is more intense when there are more competitors, incentives to fight are large, and tacit coordination is difficult.

Strategist's Toolkit: Five Forces Analysis

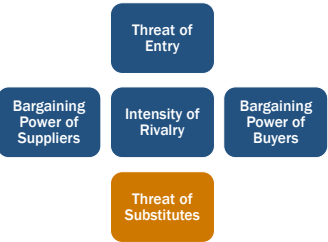
The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis



The Strategist's Toolkit:
Five Forces Analysis