MODULE I: INDUSTRY ATTRACTIVENESS

SECTIONS B & C

RC STRATEGY

ASHISH NANDA

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What Is Strategy?

Strategy is an **integrated set of choices**
that positions a firm **in its industry**
so as to create and capture superior value
over the long run

Strategy – Topics, Tasks, and Tests

External environment	• Size up the external environment of a firm in its entirety	• External consistency: Does the strategy tap the opportunities and neutralize the threats posed by the outside world in a unique manner?
Internal choices	• Configure all of a firm's choices to attain an advantage within its environment	• Internal consistency: Do the parts of the strategy fit together to form a whole that is greater than the sum of the parts?
Dynamics	• Sustain a firm's advantage over time in the face of competition	• Dynamic consistency: Does the strategy call on the company to do today what is necessary to succeed tomorrow?

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External environment
Job 1: size up the external environment of a firm in its entirety

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Course Structure

- Introduction
- **Industry attractiveness**
- Competitive advantage
- Competitive interaction
- Crafting strategy
- Corporate strategy
- Strategy across the S-curve
- Conclusion

- **Yanhai Aluminum** — *1. Cost concepts, supply curve, price forecast*
- **Cola Wars** — *2. Sizing up an industry: Five Forces*
- **AI Wars** — *3. Complements, network effects*

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Sizing Up an Industry:
The Challenge

- To craft an effective strategy, you must take account of the external environment
  - To decide whether to place your firm in an environment (entry)
  - To decide whether to extricate your firm from an environment (exit)
  - To position your firm to succeed in its industry (external alignment)
  - To assess the effect of a major change (e.g., deregulation)
  - To shape the environment
- But the environment is enormously complex

- You need a structured way of thinking about the environment
  - …that capture the richness of the real business world
  - …but separate signal from noise

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Sizing Up an Industry:
Who Faces This Challenge?

- Strategists in established companies
- Entrepreneurs
- Capital providers, public or private
- Investment bankers
- Financial analysts
- Consultants
- Anyone making a career choice

When an industry with a reputation for tough economics meets a manager with a reputation for excellent performance, it is usually the industry that keeps its reputation intact.

— Warren Buffett

Sizing Up a Commodity Industry

- In a commodity industry:
  - Usually, there are a large number of buyers and a large number of suppliers, reducing the overall power of any one buyer or supplier to influence price
  - The product is homogeneous (undifferentiated)
- In such circumstances, Price is determined by the intersection of the demand curve and the cost curve
- On a plot of Price versus Quantity:
  - **Demand curve** is developed by combining the buyers' willingness to pay (WTP) for additional quantities of the product, with the highest WTP placed on the left and additional demand being placed in declining order of WTP
  - **Cost curve** is developed by combining the sellers' willingness to supply (WTS) additional quantities of the product, with the lowest WTS placed on the left and additional supply being placed in increasing order of WTS

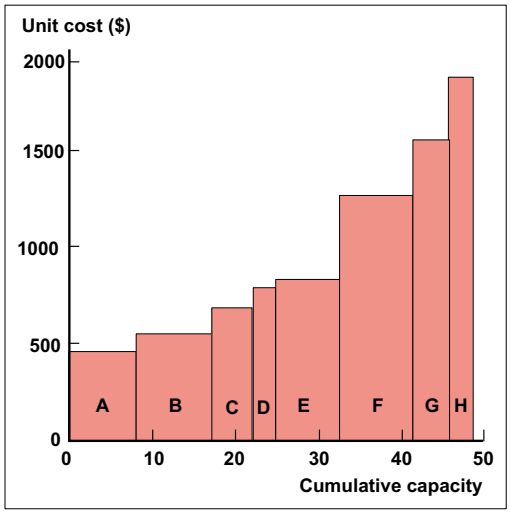
Developing a Cost Curve in a Commodity Industry: Cost Concepts

Type of Cost	Definition	Where Relevant	Decision Rule for Supplier
Marginal cost	Expenses incurred from producing an additional unit of output	Change in output	Increase output so long as price is higher than marginal cost
Non-sunk cost	Cost items that would be eliminated if the plant were shut down	Exiting existing capacity	Continue plant operations so long as price exceeds average non-sunk cost
Total cost	Total cost including non-sunk cost plus sunk cost (of which a large part usually is the annualized capital charge, which represents the investment needed to construct the plant)	Entry or capacity addition through plant construction	Enter a new market or invest in a new plant if price exceeds average total cost

Example: Taxonomy of costs for Aluminum Smelters

	Sunk	Non-sunk
Fixed	• Indirect labor (staff) • Rent • Capital costs	• Direct labor (hourly) • Marketing • Maintenance and other • Plant closing costs (negative!)
Marginal	N/A	• Electricity • Alumina • Plant fuel • Consumables • Freight • Financing

Industry Supply Curve



- An industry supply curve represents the relationship between the price of a good and the quantity of that good that all the producers in the industry are willing to supply at that price over a specific time period.
- Blocks of industry capacity are disaggregated to the extent possible
  - Usually, this disaggregation is done to the plant level. Thus, the same company may have several blocks of capacity on the supply curve, if it is producing the good at multiple locations.
  - The horizontal axis denotes the capacity contributed by the production facility.
  - The vertical axis denotes average unit cost for producing that quantity.

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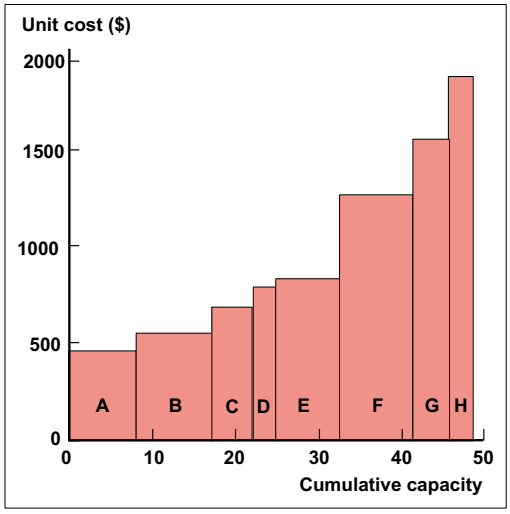
Industry Supply Curve: Relevant Costs



- Relevant costs:
  - For *new* plants: the decision is whether to build a new plant; Price > Average Total Cost
  - For *active* plants: the decision is whether to continue operating; Price > Average Non-Sunk Cost (ANSC)
  - For *inactive* plants: the decision is whether to restart production; Price > Average Total Reactivation Costs
- Construct the supply curve, arranging the producers from lowest to highest unit cost
- Equilibrium price for a commodity: Price adjusts until the quantity supplied equals the quantity demanded
  - The resulting price equals the unit cost of the marginal producer (the highest-cost producer needed to meet demand)

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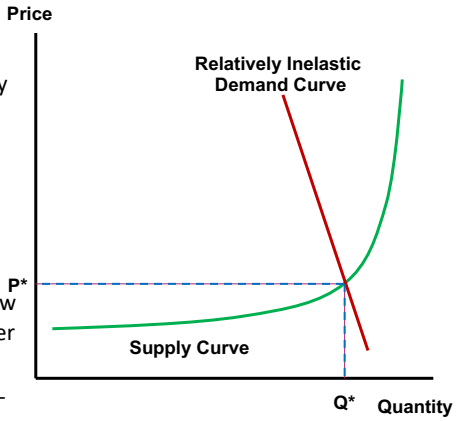
Commodity Markets

- In commodities markets:
  - Price is determined by where the demand curve intersects with the supply curve
    (Note: In markets where products are differentiated, industry supply curves don't predict market prices, but they can still help assess strategic advantages/disadvantages)
  - Firms will add capacity only if they are confident of generating an attractive ROI, accounting for their average total cost
  - However, firms that are already in the market will continue to produce so long as price exceeds their average non-sunk cost
  - Thus, new capacity will be added only if average total cost of the new plant is as low as the average non-sunk cost of the marginal producer
  - If sunk cost is high, the gap between average total cost and the average non-sunk cost is large; also, often, adding capacity is a time-intensive task
  - These dynamics makes adding capacity in the short term in response to demand increase particularly challenging
  - Significant addition of capacity moves the industry supply curve to the right, thereby depressing market price



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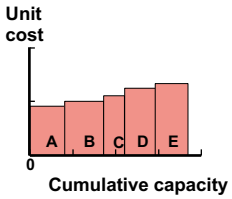
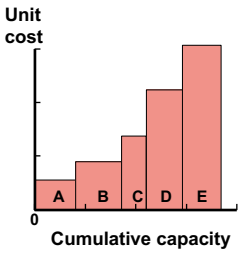
Flat vs. Steep Supply Curves

- A flat supply curve implies low profitability for most of the players.
  It usually exists when:
  - Technologies and production processes are common
  - Imitation of technical know-how is easy
  - Industry participants focus on continuous cost improvement



- A steep cost curve implies high profitability for more cost-efficient producers
  It usually exists when:
  - Technologies and production processes are different across producers
  - Imitation of technical know-how is difficult
  - Industry participants focus on building and maintaining proprietary know-how



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Price Fluctuations in Commodity Markets and Investment Decisions in Commodity Industries

- In commodity industries with high sunk cost:
  - The supply curve has a relatively steep section beyond the current capacity
  - The demand curve intersects with the supply curve near the kink

  This leads to significant price fluctuations
- If the demand curve is relatively inelastic in the short-run (demand does not change significantly with price), this leads to significant price fluctuations and, in the short run, an asymmetric impact on price, based on change in demand
  - If demand declines, the new equilibrium is at a lower point on the supply curve, which is typically at a slightly lower price and lower overall quantity
  - If demand increases, the new equilibrium is at a slightly higher quantity but a significantly higher price.
- When sunk costs are high and investments yield returns over long horizons, predicting how price will evolve becomes a key component of the investment decision
  - China Hongqiao Group (Yanhai case) was astute, in retrospect, for investing in phase one and phase two expansions of the Yunnan plant, even though Aluminum price was at a historic low; their bet that price would rise eventually paid off handsomely
  - In contrast, Rio Tinto's $44 b acquisition of Alcan in 2007, at a time when Aluminum price was at a historic high, was an unmitigated disaster

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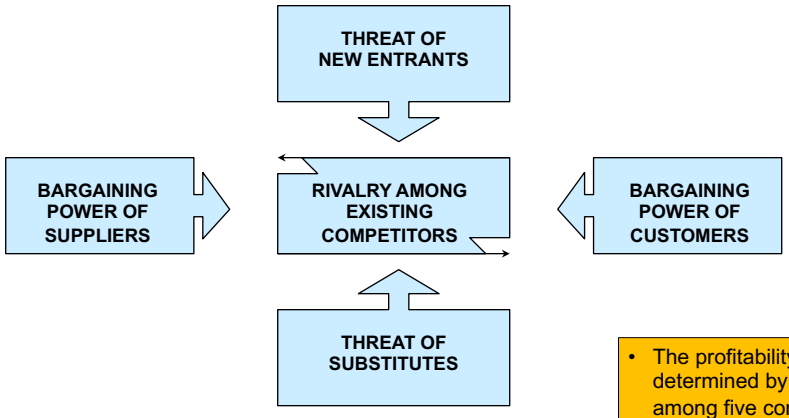
Sizing Up an Oligopolistic Industry: Five Forces Framework



- The profitability of an industry is determined by the balance among five competitive forces
- Even one bad force is enough to drive the profit out of an industry

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Sizing Up an Oligopolistic Industry:
Uses of the Five Forces Framework

- Distinguish structurally attractive industries with high long-run profit potential from unattractive industries with low potential
- Steer the firm toward good positions within an industry and away from bad positions
  - You can make good money in a tough industry, but to do so, you must find a way to deal well with the Five Forces (external alignment)
- Catalog, assess, and prioritize the impact of exogenous changes on industry attractiveness and required strategy
  - e.g., technology, demographic, public policy
- Identify actions you might take yourself to change your industry for the better or to avoid changing it for the worse

Sizing Up an Oligopolistic Industry:
Typical Steps in an Industry Analysis

Virtually any Five Forces analysis will include certain steps

- Define the industry: What is in? What is out?
- Identify the players
  - e.g., Who are the customers, really? Are we considering all the players in the supply chain? Who are the competitors?
- Assess the strength of each force
  - See industry analysis note for a comprehensive set of factors to consider
- Sniff-test
  - Is the assessment in line with actual profitability?
  - Are more profitable players better positioned vis-a-vis industry forces?
- Assess changes and trends in each of the forces

Sizing Up an Oligopolistic Industry: Common Pitfalls

- Assuming that competition comes only from (direct) competitors
  - In fact, customers, suppliers, substitutes, and potential entrants also compete to capture value
- Paying too little attention to substitutes
  - They can be subtle (e.g., Zoom for air travel) and therefore may be easy to miss
- Failing to manage complements (e.g., AI industry)
- Focusing on the average rival, customer, supplier, etc., rather than the most challenging rival, customer, supplier, etc.
- Confusing evidence of a force with its underlying cause
  - e.g., assuming customer price sensitivity is because of customer bargaining power rather than exploring why customers are sensitive to price
- Paying equal attention to all the forces

Sizing Up an Oligopolistic Industry: Common Pitfalls (continued)

- Failing to define the industry clearly
  - A clear definition is more important that the "right" definition
- Ignoring changes in structural forces
  - Failing to examine shifts in factors that drive the competitive forces (e.g., regulation, politics, technology, demographics, and so on)
- Confusing transient effects with lasting changes in structural forces
- Assuming that competitive forces cannot be altered
- Assuming that competitive forces can be altered at will
- Gathering data rather than conducting analysis
- Conducting analysis rather than drawing implications for action

Sizing Up an Oligopolistic Industry:

Some Good Habits

- Use the income statement of a typical company in an industry to: size up fixed/ marginal costs, understand economics of scale, identify major suppliers, etc.
- Use analogies and counterexamples to deepen your understanding of forces:
  - If brands drive profitability in soft drinks, why are heavily branded industries like autos, airlines, and PCs often unprofitable?
  - If bottlers are weak because they lack brands, why do cable operators (which lack brands and "bottle" the content of others) make good money?
  - Part of the power of the case method: It gives you access to many analogies
- Build up a repertoire of responses to competitive forces
  - Strong customer power ⇒ build switching costs, find loyal segments, integrate downstream, look for unmet latent needs, etc.
  - Major threat of substitutes ⇒ enter substitutes' markets, find ways to incorporate benefits (e.g., calcium-supplemented OJ vs. milk)
- Know your industry's history
  - Every 10-20 years, someone has tried to roll up the furniture industry…and has failed. Maybe this tells you something about the industry's structure

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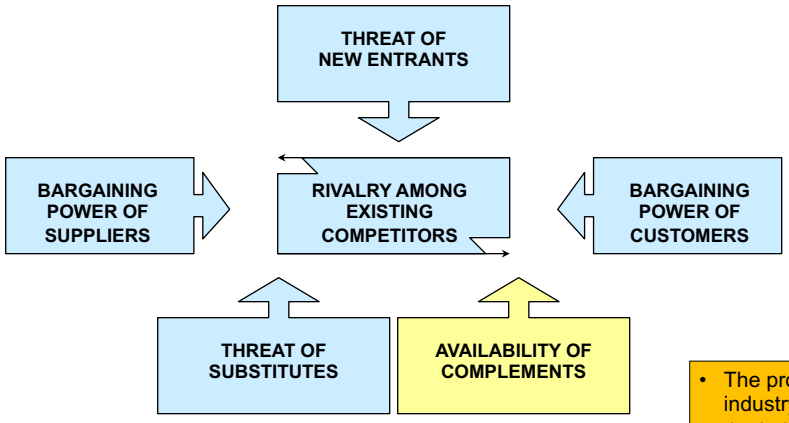
Sizing Up an Oligopolistic Industry:

The Role of Complements



- The profitability of an industry is determined by the balance among five competitive forces + complements

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Sizing Up an Industry:

The Role of Complements

- Complement increase the overall demand for the focal good
  - Examples: conventional cars and gasoline, printers and ink cartridges, shoes and socks, hot dogs and buns
  - Particularly prevalent in high-tech industries
- Good news: they expand the pie
  Bad news: they want their slice
- Success of the focal industry can depend on the availability, pricing, and quality of the complements
  - Examples: Video game platforms and game libraries; mobile operating systems and apps; Wintel in PCs
- Firms that are present in complementary industries can price strategically
  - Examples: Razors and blades, web browsers and search engines
- Firms with dominant positions in a strong complement can exert bargaining power on focal industry
  - Example: Wintel v. Hardware
- Strong complements create ecosystems
  Since complements reinforce each other, customer lock-in increases
  - Example: The Apple ecosystem: iPhone, app store, air pods, iCloud, Apple watch

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On to Job 2

Competitive Advantage
Job 2: Configure all activities to create a larger gap between willingness to pay and cost than that achieved by competitors for the target customer segments

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that positions a firm in its industry
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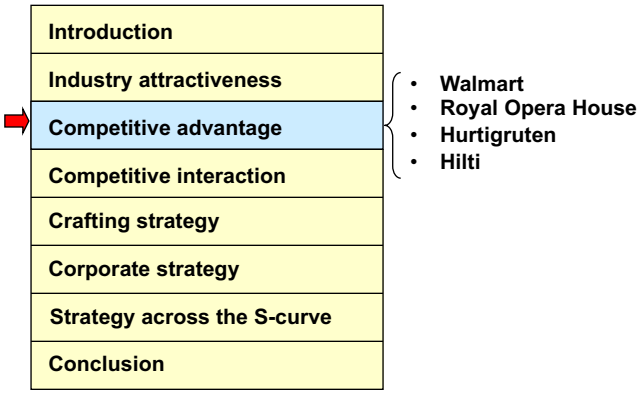
Course Architecture



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