Competitor Analysis

What is it?

Competitor analysis is a framework for evaluating current or potential competitors of a firm. While deceptively simple, a competitive analysis is an indispensable tool in the strategist's toolkit.

When do we use it?

While competitor analysis is by nature only one component of a more robust strategic analysis that employs multiple frameworks and tools, it can be a useful starting point for thinking about competitive dynamics and analyzing the industry in greater detail.

Why do we use it?

A good strategic analysis requires an analysis of the firm's competition in order to be able to assess and predict the sustainability of any competitive advantage and the response of rivals to various strategic actions. Competitor analysis can help firms make strategic decisions and gather competitive intelligence on the industry. A detailed competitor analysis can help firms influence their rivals' behavior to their own advantage.

When assessing a firm's strategy and its capacity to create value for important stakeholders, it is important to keep in mind the *fundamental principle* of competition: If everyone can do it, it's difficult to create and capture value from it. Strategy plays out in the competitive arena. How will competitors react to the strategic moves of a business? Will they be able to imitate those moves? How will other stakeholders—say, customers or the community—respond? In the words of Sharon Oster, "Strategy must be devised and implemented with an appreciation of these second-order effects."[5]

To illustrate the fundamental principle, consider a vendor selling T-shirts outside the University of Virginia's basketball arena. This vendor does quite well for herself selling a desired product at a reasonable markup over costs; her enterprise provides a good return for the vendor and a product customers find desirable. But how do others respond? Absent any barriers to entry, other T-shirt vendors may soon appear outside the arena. Absent any barriers to imitation, they may, in fact, sell exact replicas of the T-shirts she is currently selling. As the supply of T-shirts increases, the competition for customers becomes stiffer, and vendors start lowering their prices to attract customers. Soon enough, prices fall to the point that the next potential T-shirt vendor elects not

5. Sharon Oster, *Modern Competitive Analysis* (Oxford: Oxford University Press, 1999), 11.

to enter because the opportunity cost is too high and his next best option for a business venture is more attractive than becoming a T-shirt vendor. The remaining vendors may profit from their ventures but will likely make no more than their opportunity cost. This is what economists refer to as *economic profit* or *economic rents*. It differs from accounting profit in that it refers to profits in excess of the opportunity cost of capital.

The fundamental principle of competition implies that a successful strategy requires some barrier to competition that prevents others from entering a firm's market and imitating its strategy. In the case of our T-shirt vendor, restrictions that require permission to sell outside the arena, in the form of a license or permit, would serve as a barrier to entry. Copyright and trademarks could serve as barriers to imitation of the initial vendor's T-shirt designs. Together, barriers to entry and barriers to imitation can reduce competitive pressures and allow our T-shirt vendor to thrive. Only in the presence of such barriers to competition can a firm be expected to earn a stream of economic profits into the future.

Ultimately, this expected stream of economic profits is reflected in the firm's market value. The market valuation of a firm reflects investors' expectations of the future discounted stream of free cash flows accruing to the firm. Free cash flows are defined as those funds remaining from revenues after operating costs, taxes, net investments, and changes in working capital are deducted. Another way to think about free cash flows is net operating profit after taxes (NOPAT) less investments. We discount this stream because cash in the future is arguably worth less than cash today. A thorough strategic analysis can help one forecast future cash flows for a firm and thus calculate an expected market value for the firm.

How do we use it?

Step 1. Identify competitors.

While seemingly straightforward, competitor identification is a critical, and often challenging, first step in a competitor analysis. Two companies in the same industry may vary significantly in the degree to which they compete. They may compete in different geographic markets or target radically different customer segments. For example, is there much use to Porsche, a luxury sports car manufacturer, in analyzing Kia, a builder of low-cost sedans? In some cases, even identifying a company's industry can be difficult.

There are two common ways to identify competition. The first is to look at the industry from a customer's viewpoint and group all firms providing a similar product or service. Marketers have developed various techniques such as perception mapping and brand-switching analyses to aid in identifying the most relevant competitors. Point-of-sales and scanner data provide rich sources to help with such analyses. The gold standard is to identify the cross-price elasticity between pairs of products (i.e., the percentage increase in demand for one product given a 1% decrease in price for another product). The larger the increase in demand, the more those two products are substitutes and their makers rivals. In practice, however, cross-price elasticity can be difficult to calculate.

The second approach is to carry out a detailed analysis of industry players and group firms with similar strategies as competitors. For example, if analyzing the U.S. steel industry, it may be useful to classify companies into three strategic groups: large integrated steel mills, mini-mills (which use a different technology), and foreign importers. It may also be worthwhile to collect data on those who provide related products; for example, aluminum and plastic manufacturers as alternative competitors in the case of the steel industry. By clustering competitors into strategic groups, you can prioritize your intelligence gathering, focusing first and foremost on those rivals most closely related to the focal firm while also being cognizant of more distant competitors. Strategic group identification can be a quick and easy approach in many situations.

Step 2. Gather intelligence.

Once the competition has been identified, data can be gathered to provide insight on the competitor(s). These include historical data such as shareholder reports or SEC filings as well as press releases, media coverage, interviews with analysts and managers, and public relations events. Recent performance, existing strategies, and organizational capabilities can also be studied by examining the firm's hiring activity and patterns, research and development activity, capital investments, and strategic partnerships.

Competitor information can be pulled together in a simple spreadsheet (**Figure 2**):

Figure 2. Competitor information spreadsheet.

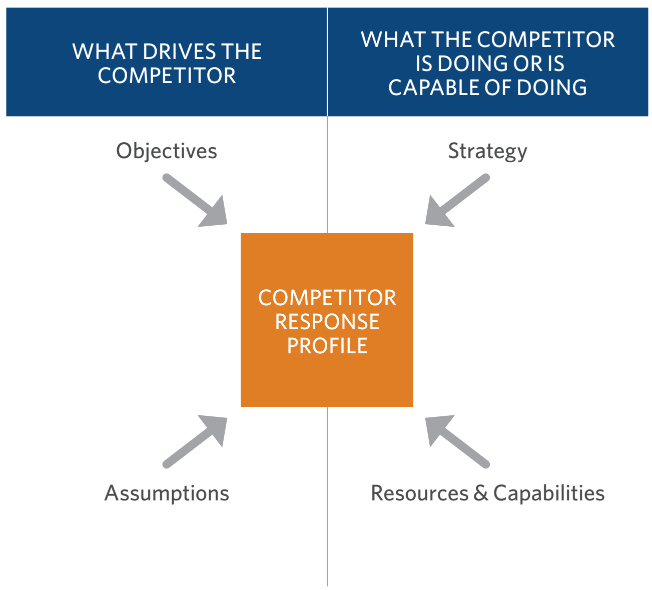
	REVENUES	MARKET SHARE	ROA	R&D INVESTMENT	STRATEGIC PARTNERSHIPS
Focal Firm					
Strategic Group 1					
Competitor 1					
Competitor 2					
Competitor 3					
Competitor 4					
Strategic Group 2					
Competitor 1					
Competitor 2					
Competitor 3					
Competitor 4					
Strategic Group 3					
Competitor 1					
Competitor 2					
Competitor 3					
Competitor 4					

Step 3. Analyze rivals.

The final step is analyzing the competitive positions of rivals and comparing their relative strengths and weaknesses. The simple diagram in **Figure 3** is a useful guidepost for thinking about competitive responses. First, what drives a given competitor? What are its objectives and its operating assumptions? Second, what is the competitor capable of doing? How do its strategy, resources, and capabilities allow it to compete now and in the future?

While this last part of a competitor analysis is the most subjective, it can provide useful insights into the sustainability of a focal firm's competitive advantage and to how competitors may respond to specific strategic actions by the focal firm.

Figure 3. Competitor positions.



Adapted from Michael E. Porter, *Competitive Strategy*

FURTHER READING

Chapter 4 of R. Grant, *Contemporary Strategic Analysis* (Blackwell Publishers, 2008).