

The Competitive Environment

LO2.5

How forces in the competitive environment can affect profitability, and how a firm can improve its competitive position by increasing its power vis-à-vis these forces.

Managers must consider the competitive environment (also sometimes referred to as the task or industry environment). The nature of competition in an industry, as well as the profitability of a firm, is often directly influenced by developments in the competitive environment.

Industry a group of firms that produce similar goods or services.

The competitive environment consists of many factors that are particularly relevant to a firm's strategy. These include competitors (existing or potential), customers, and suppliers. Potential competitors may include a supplier considering forward integration, such as an automobile manufacturer acquiring a rental car company, or a firm in an entirely new industry introducing a similar product that uses a more efficient technology.

competitive environment factors that pertain to an industry and affect a firm's strategies.

Next, we will discuss key concepts and analytical techniques that managers should use to assess their competitive environments. First, we examine Michael Porter's five-forces model that illustrates how these forces can be used to explain an industry's profitability.⁵³ Second, we discuss how the five forces are being affected by the capabilities provided by Internet technologies. Third, we address some of the limitations, or “caveats,” that managers should be familiar with when conducting industry analysis. Finally, we address the concept of strategic groups, because even within an industry it is often useful to group firms on the basis of similarities of their strategies. As we will see, competition tends to be more intense among firms *within* a strategic group than between strategic groups.

Porter's Five Forces Model of Industry Competition

The “five forces” model developed by Michael E. Porter has been the most commonly used analytical tool for examining the competitive environment. It describes the competitive environment in terms of five basic competitive forces.⁵⁴

Porter's five forces model of industry competition a tool for examining the industry-level competitive environment, especially the ability of firms in that industry to set prices and minimize costs.

1. The threat of new entrants.
2. The bargaining power of buyers.
3. The bargaining power of suppliers.
4. The threat of substitute products and services.

5. The intensity of rivalry among competitors in an industry.

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Each of these forces affects a firm's ability to compete in a given market. together, they determine the profit potential for a particular industry. the model is shown in Exhibit 2.4. A manager should be familiar with the five forces model for several reasons. It helps you decide whether your firm should remain in or exit an industry. It provides the rationale for increasing or decreasing resource commitments. the model helps you assess how to improve your firm's competitive position with regard to each of the five forces.⁵⁵ For example, you can use insights provided by the five forces model to understand how higher entry barriers that discourage new rivals from competing with you.⁵⁶ or how to develop strong relationships with your distribution channels. You may decide to find suppliers who satisfy the price/performance criteria needed to make your product or service a top performer.

EXHIBIT 2.4 Porter's Five Forces Model of Industry Competition

Porter's Five Forces Model of Industry Competition

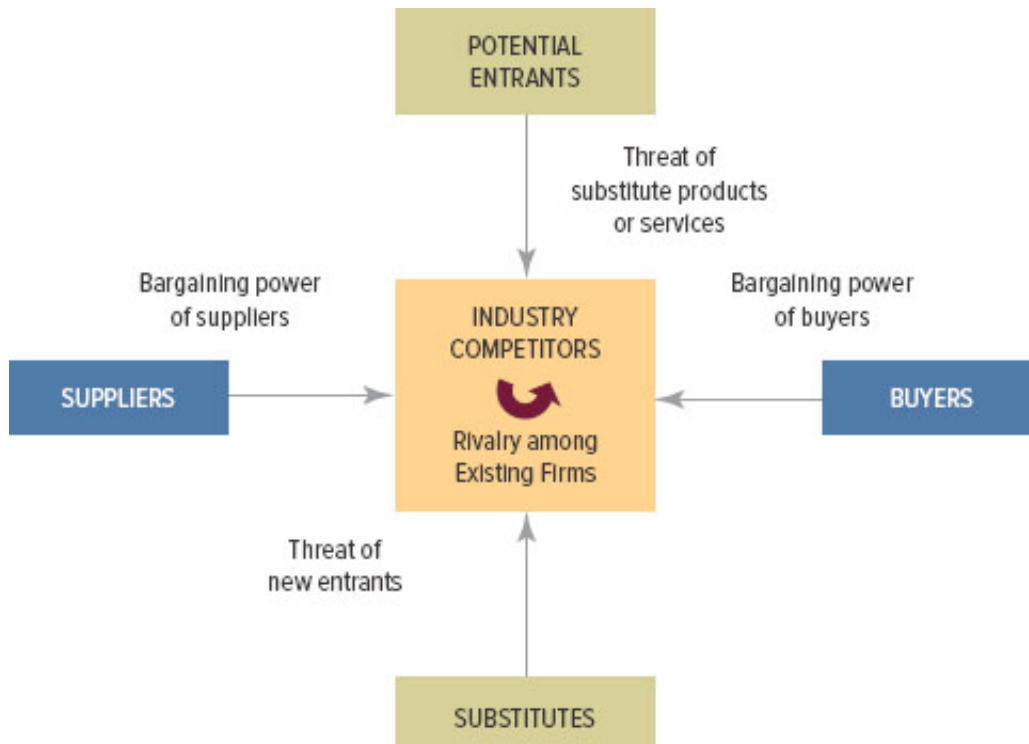


EXHIBIT 2.4

Porter's Five Forces Model of Industry Competition Porter's Five Forces Model of Industry Competition
Sources: From Michael E. Porter, "The Five Competitive Forces That shape strategy," Special Issue on HBS Centennial. Harvard Business Review 86, No. 1 (January 2008), 78–93. Reprinted with permission of Michael E. Porter.

The Threat of New Entrants

The Threat of New Entrants The threat of new entrants refers to the possibility that the profits of established firms in the industry may be eroded by new competitors.⁵⁷ the extent of the threat depends on existing barriers to entry and the combined reactions from existing competitors.⁵⁸ If entry barriers are high and/or the

newcomer can anticipate a sharp retaliation from established competitors, the threat of entry is low. these circumstances discourage new competitors. there are six major sources of entry barriers.

threat of new entrants the possibility that the profits of established firms in the industry may be eroded by new competitors.

Economies of scale

Economies of scale Economies of scale refers to spreading the costs of production over the number of units produced. the cost of a product per unit declines as the absolute volume per period increases. this deters entry by forcing the entrant to come in at a large scale and risk strong reaction from existing firms or come in at a small scale and accept a cost disadvantage. Both are undesirable options.

economies of scale decreases in cost per unit as absolute output per period increases.

Product Differentiation

Product Differentiation When existing competitors have strong brand identification and customer loyalty, product differentiation creates a barrier to entry by forcing entrants to spend heavily to overcome existing customer loyalties.

product differentiation the degree to which a product has strong brand loyalty or customer loyalty.

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Capital Requirements

Capital Requirements The need to invest large financial resources to compete creates a barrier to entry, especially if the capital is required for risky or unrecoverable up-front advertising or research and development (R&D).

Switching Costs

Switching Costs A barrier to entry is created by the existence of one-time costs that the buyer faces when switching from one supplier's product or service to another.

Switching costs one-time costs that a buyer/supplier faces when switching from one supplier/buyer to another.

Access to Distribution Channels

Access to Distribution Channels The new entrant's need to secure distribution for its product can create a barrier to entry.

Cost Disadvantages Independent of Scale

Cost Disadvantages Independent of Scale Some existing competitors may have advantages that are independent of size or economies of scale. These derive from:

- Proprietary products
- Favorable access to raw materials
- Government subsidies
- Favorable government policies

Managers often tend to overestimate the barriers of entry in many industries. There are any number of cases where new entrants found innovative ways to enter industries by cleverly mixing and matching existing technologies. For example, companies, medical researchers, governments, and others are creating breakthrough technology products *without having to create any new technology*.⁵⁹ Geoff Colvin, a senior editor at *Fortune*, calls this “the era of Lego Innovation,” in which significant and valuable advances in technology can be achieved by imaginatively combining components and software available to everyone. Such a trend serves to reduce entry barriers in many industries because state-of-the-art technology does not have to be developed internally—rather, it is widely available and, Colvin asserts, “we all have access to a really big box of plastic bricks.”

MIT's Media Lab has created robots powered by Android smartphones. After all, those devices can see, hear, recognize speech, and talk; they know where they are, how they're oriented, and how fast they're moving. And, through apps and an Internet connection, they can do a nearly infinite number of other tasks, such as recognize faces and translate languages. Similarly, teams at the University of South Carolina combined off-the-shelf eye-tracking technology with simple software they wrote to detect whether a driver was getting drowsy; any modern car has enough computing power to handle this job easily.

bargaining power of buyers the threat that buyers may force down prices, bargain for higher quality or more services, and play competitors against each other.

The Bargaining Power of Buyers

The Bargaining Power of Buyers Buyers threaten an industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other. these actions erode industry profitability.⁶⁰ the power of each large buyer group depends on attributes of the market situation and the importance of purchases from that group compared with the industry's overall business. A buyer group is powerful when:

- ***It is concentrated or purchases large volumes relative to seller sales.*** If a large percentage of a supplier's sales are purchased by a single buyer, the importance of the buyer's business to the supplier increases. Large-volume buyers also are powerful in industries with high fixed costs (e.g., steel manufacturing).
- ***The products it purchases from the industry are standard or undifferentiated.*** Confident they can always find alternative suppliers, buyers play one company against the other, as in commodity grain products.
- ***The buyer faces few switching costs.*** switching costs lock the buyer to particular sellers. Conversely, the buyer's power is enhanced if the seller faces high switching costs.

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- ***It earns low profits.*** Low profits create incentives to lower purchasing costs. On the other hand, highly profitable buyers are generally less price-sensitive.
- ***The buyers pose a credible threat of backward integration.*** If buyers either are partially integrated or pose a credible threat of backward integration, they are typically able to secure bargaining concessions.
- ***The industry's product is unimportant to the quality of the buyer's products or services.*** When the quality of the buyer's products is not affected by the industry's product, the buyer is more price-sensitive.

At times, a firm or set of firms in an industry may increase its buyer power by using the services of a third party. FreeMarkets Online is one such third party.⁶¹ Pittsburgh-based FreeMarkets has developed software enabling large industrial buyers to organize online auctions for qualified suppliers of semistandard parts such as fabricated components, packaging materials, metal stampings, and services. By aggregating buyers, Free Markets increases the buyers' bargaining power. The results are impressive. In its first 48 auctions, most participating companies saved over 15 percent; some saved as much as 50 percent.

Although a firm may be tempted to take advantage of its suppliers because of high buyer power, it must be aware of the potential long-term backlash from such actions. A recent example is the growing resentment that students have toward state universities in California because of a steep 32 percent increase in tuition. Let's see why they have so little bargaining power.

Students protested by taking over a classroom building. As noted by *Forbes* writer Asher Hawkins: "It was a futile effort. Students who are already embarked on a four-year program are something of a captive audience, and California's state coffers are empty."⁶² After all, students have high exit costs, primarily because of the difficulty in transferring credits to another university. Plus, there are fewer openings at other UC campuses due to budget cuts, and there is increasing demand for them from overseas students. All these factors erode student bargaining power.

After the increase, the tuition and fees for in-state undergraduate students will come to about \$10,000 for the academic year (this represents a compound annual increase of nearly 10 percent over the past decade). Although this may still seem like a reasonable price for a high-quality education, there could be more price increases ahead.

bargaining power of suppliers The threat that suppliers may raise prices or reduce the quality of purchased goods and services.

The Bargaining Power of suppliers

The Bargaining Power of suppliers Suppliers can exert bargaining power by threatening to raise prices or reduce the quality of purchased goods and services. Powerful suppliers can squeeze the profitability of firms so far that they can't recover the costs of raw material inputs.⁶³ The factors that make suppliers powerful tend to mirror those that make buyers powerful. A supplier group will be powerful when:

- ***The supplier group is dominated by a few companies and is more concentrated (few firms dominate the industry) than the industry it sells to.*** Suppliers selling to fragmented industries influence prices, quality, and terms.
- ***The supplier group is not obliged to contend with substitute products for sale to the industry.*** The power of even large, powerful suppliers can be checked if they compete with substitutes.
- ***The industry is not an important customer of the supplier group.*** When suppliers sell to several industries and a particular industry does not represent a significant fraction of its sales, suppliers are more prone to exert power.
- ***The supplier's product is an important input to the buyer's business.*** When such inputs are important to the success of the buyer's manufacturing process or product quality, the bargaining power of suppliers is high.

- ***The supplier group's products are differentiated, or it has built up switching costs for the buyer.*** Differentiation or switching costs facing the buyers cut off their options to play one supplier against another.
- ***The supplier group poses a credible threat of forward integration.*** This provides a check against the industry's ability to improve the terms by which it purchases.

The formation of Delta Pride Catfish is an example of the power a group of suppliers can attain if they exercise the threat of forward integration.⁶⁴ Catfish farmers in Mississippi historically supplied their harvest to processing plants run by large agribusiness firms such as ConAgra and Farm Fresh. When the farmers increased their production of catfish in response to growing demand, they found, much to their chagrin, that processors were holding back on their plans to increase their processing capabilities in hopes of higher retail prices for catfish.

What action did the farmers take? About 120 of them banded together and formed a cooperative, raised \$4.5 million, and constructed their own processing plant, which they supplied themselves. ConAgra's market share quickly dropped from 35 percent to 11 percent, and Farm Fresh's market share fell by over 20 percent. Within 10 years, Delta Pride controlled over 40 percent of the U.S. catfish market. Recently, Delta Pride changed its ownership structure and became a closely-held corporation. In 2014, it had revenues of \$80 million, employed 600 people, and processed 80 million pounds of catfish.

threat of substitute products and services The threat of limiting the potential returns of an industry by placing a ceiling on the prices that firms in that industry can profitably charge without losing too many customers to substitute products.

The Threat of Substitute Products and Services

The Threat of Substitute Products and Services All firms within an industry compete with industries producing substitute products and services.⁶⁵ substitutes limit the potential returns of an industry by placing a ceiling on the prices that firms in that industry can profitably charge. the more attractive the price/performance ratio of substitute products, the tighter the lid on an industry's profits.

Substitute products and services products and services outside the industry that serve the same customer needs as the industry's products and services.

Identifying substitute products involves searching for other products or services that can perform the same function as the industry's offerings. this may lead a manager into businesses seemingly far removed from the industry. For example, the airline industry might not consider video cameras much of a threat. But as digital technology has improved and wireless and other forms of telecommunication have become more efficient, teleconferencing has become a viable substitute for business travel. that is, the rate of improvement in the price–performance relationship of the substitute product (or service) is high.

Consider the case of hybrid cars as a substitute for gasoline-powered cars.⁶⁶ Hybrid cars, such as the Toyota Prius, have seen tremendous success since the first hybrids were introduced in the late 1990s. Yet the market share of hybrid cars has been consistently low—reaching 2.4 percent in 2009, rising to 3.3 percent (the peak) in 2013, and declining to only 3 percent in 2014. Such results are even more surprising given that the number of models almost doubled between 2009 and 2014—24 to 47. That's more choices, but fewer takers. While some may believe the hybrid car industry feels pressure from other novel car segments such as electric cars (e.g., Nissan Leaf), the primary competition comes from an unusual suspect: plain old gas combustion cars.

The primary reason many environmental and cost-conscious consumers prefer gasoline-powered over hybrid cars is rather simple. Engines of gasoline-powered cars have increasingly challenged the key selling attribute of hybrid cars: fuel economy. While hybrid cars still slightly outcompete modern gasoline cars in terms of fuel economy, consumers increasingly don't see the value of paying as much as \$6,000 extra for a hybrid car when they can get around 40 mpg in a gasoline car such as the Chevrolet Cruz or Hyundai Elantra.

intensity of rivalry among competitors in an industry The threat that customers will switch their business to competitors within the industry.

The Intensity of Rivalry among Competitors in an Industry

The Intensity of Rivalry among Competitors in an Industry Firms use tactics like price competition, advertising battles, product introductions, and increased customer service or warranties. Rivalry occurs when competitors sense the pressure or act on an opportunity to improve their position.⁶⁷

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Some forms of competition, such as price competition, are typically highly destabilizing and are likely to erode the average level of profitability in an industry.⁶⁸ Rivals easily match price cuts, an action that lowers profits for all firms. On the other hand, advertising battles expand overall demand or enhance the level of product differentiation for the benefit of all firms in the industry. Rivalry, of course, differs across industries. In some instances it is characterized as warlike, bitter, or cutthroat, whereas in other industries it is referred to as polite and gentlemanly. Intense rivalry is the result of several interacting factors, including the following:

- **Numerous or equally balanced competitors.** When there are many firms in an industry, the likelihood of mavericks is great. Some firms believe they can make moves without being noticed. Even when there are relatively few firms, and they are nearly equal in size and resources, instability results from fighting among companies having the resources for sustained and vigorous retaliation.
- **Slow industry growth.** Slow industry growth turns competition into a fight for market share, since firms seek to expand their sales.
- **High fixed or storage costs.** High fixed costs create strong pressures for all firms to increase capacity. Excess capacity often leads to escalating price cutting.
- **Lack of differentiation or switching costs.** Where the product or service is perceived as a commodity or near commodity, the buyer's choice is typically based on price and service, resulting in pressures for intense price and service competition. Lack of switching costs, described earlier, has the same effect.
- **Capacity augmented in large increments.** Where economies of scale require that capacity must be added in large increments, capacity additions can be very disruptive to the industry supply/demand balance.
- **High exit barriers.** Exit barriers are economic, strategic, and emotional factors that keep firms competing even though they may be earning low or negative returns on their investments. Some exit barriers are specialized assets, fixed costs of exit, strategic interrelationships (e.g., relationships between the business units and others within a company in terms of image, marketing, shared facilities, and so on), emotional barriers, and government and social pressures (e.g., governmental discouragement of exit out of concern for job loss).

Rivalry between firms is often based solely on price, but it can involve other factors. Consider, for example,

the intense competition between Uber Technologies Inc. and Lyft Inc., which are engaged in a fierce, ongoing battle in the taxi industry:⁶⁹

The bitter war between Uber and Lyft has spilled into dozens of cities where they are racing to provide the default app for summoning a ride within minutes. The two rivals are busy undercutting each other's prices, poaching drivers, and co-opting innovations. These actions have increasingly blurred the lines between the two services.

The potential market for these firms may stretch far beyond rides. Investors who have bid up the value of Uber to over \$18.2 billion in June 2014 are betting that it can expand into becoming the backbone of a logistics and delivery network for various services—a type of FedEx for cities.

The recruitment of drivers is the lifeblood for the services as they attempt to build the largest networks with the fastest pickup times. For example, many Uber drivers are motivated to poach Lyft's drivers in order to get a bounty—\$500 for referring a Lyft driver and \$1,000 for referring a Lyft “mentor,” an experienced Lyft contractor who helps train new drivers.

In June 2014, another shot over the bow took place when both companies unveiled similar carpooling services within hours of each other. Lyft Line and Uber Pool let passengers ride with strangers and split the bill—lowering the cost of regular commutes. Lyft claims that it had been developing the carpooling model for several years and acquired a team to lead the effort months ago, according to John Zimmer, Lyft's president. He adds, “I think it's flattering when other companies look at how we're innovating and want to do similar things.”

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On the other hand, Lyft has borrowed heavily from Uber, which had originated a real-time map that showed nearby drivers. Lyft's design is quite similar. Further, Lyft's “prime time” prices for peak-demand times are a variation of Uber's surge pricing.

The ease with which both firms can imitate each other's features may lead one to believe that the ride-sharing industry has low barriers to entry. After all, since Uber and Lyft don't own cars or employ chauffeurs, they are basically matchmakers between drivers and passengers. However, investors who have poured \$2 billion into the two rivals are betting the apps will have staying power. Millions of people are now used to riding with Uber, and the app is still one of the most popular programs in Apple's App store. Says Bill Gurley, a partner at Benchmark, a large diversified financial services firm, and a member of Uber's board: "Being installed on someone's iPhone on the home page is a pretty sticky place to be."

Exhibit 2.5 summarizes our discussion of industry five-forces analysis. It points out how various factors, such as economies of scale and capital requirements, affect each “force.”

EXHIBIT 2.5 Competitive Analysis Checklist

Competitive Analysis Checklist



Threat of New Entrants Is High When:

High Low

Economies of scale are	X
Product differentiation is	X
Capital requirements are	X
Switching costs are	X
Incumbent's control of distribution channels is	X
Incumbent's proprietary knowledge is	X
Incumbent's access to raw materials is	X
Incumbent's access to government subsidies is	X

Power of Buyers Is High When:

HighLow

Concentration of buyers relative to suppliers is	X
Switching costs are	X
Product differentiation of suppliers is	X
Threat of backward integration by buyers is	X
Extent of buyer's profits is	X
Importance of the supplier's input to quality of buyer's final product is	X

Power of suppliers Is High When:

HighLow

Concentration relative to buyer industry is	X
Availability of substitute products is	X

Importance of customer to the supplier is	X
Differentiation of the supplier's products and services is	X
Switching costs of the buyer are	X
Threat of forward integration by the supplier is	X
Threat of Substitute Products Is High when:	HighLow
Differentiation of the substitute product is	X
Rate of improvement in price–performance relationship of substitute product is	X
Intensity of Competitive Rivalry Is High when:	High Low
Number of competitors is	X
Industry growth rate is	X
Fixed costs are	X
Storage costs are	X
Product differentiation is	X
Switching costs are	X
Exit barriers are	X
Strategic stakes are	X

EXHIBIT 2.5
Competitive Analysis Checklist Competitive Analysis Checklist

How the Internet and Digital Technologies Are Affecting the Five Competitive Forces

LO2.6

How the Internet and digitally based capabilities are affecting the five competitive forces and industry profitability.

The Internet is having a significant impact on nearly every industry. Internet-based and digital technologies have fundamentally changed the ways businesses interact with each other and with consumers. In most cases, these changes have affected industry forces in ways that have created many new strategic challenges. In this section, we will evaluate Michael Porter's five-forces model in terms of the actual use of the Internet and the new technological capabilities that it makes possible.

Internet a global network of linked computers that use a common transmission format, exchange information, and store data.

The Threat of New Entrants

The Threat of New Entrants In most industries, the threat of new entrants has increased because digital and Internet-based technologies lower barriers to entry. For example, businesses that reach customers primarily through the Internet may enjoy savings on other traditional expenses such as office rent, sales-force salaries, printing, and postage. This may encourage more entrants who, because of the lower start-up expenses, see an opportunity to capture market share by offering a product or performing a service more efficiently than existing competitors. Thus, a new cyber entrant can use the savings provided by the Internet to charge lower prices and compete on price despite the incumbent's scale advantages.

Alternatively, because digital technologies often make it possible for young firms to provide services that are equivalent or superior to an incumbent, a new entrant may be able to serve a market more effectively, with more personalized services and greater attention to product details. A new firm may be able to build a reputation in its niche and charge premium prices. By so doing, it can capture part of an incumbent's business and erode profitability.

Another potential benefit of web-based business is access to distribution channels. Manufacturers or distributors that can reach potential outlets for their products more efficiently by means of the Internet may enter markets that were previously closed to them. Access is not guaranteed, however, because strong barriers to entry exist in certain industries.⁷⁰

The Bargaining Power of Buyers

The Bargaining Power of Buyers The Internet and wireless technologies may increase buyer power by providing consumers with more information to make buying decisions and by lowering switching costs. But these technologies may also suppress the power of traditional buyer channels that have concentrated buying power in the hands of a few, giving buyers new ways to access sellers. To sort out these differences, let's first distinguish between two types of buyers: end users and buyer channel intermediaries.

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End users are the final customers in a distribution channel. Internet sales activity that is labeled “B2C”—that is, business-to-consumer—is concerned with end users. The Internet is likely to increase the power of these buyers for several reasons. First, the Internet provides large amounts of consumer information. This gives end users the information they need to shop for quality merchandise and bargain for price concessions. Second, an end user's switching costs are potentially much lower because of the Internet. Switching may involve only a few clicks of the mouse to find and view a competing product or service online.

In contrast, the bargaining power of distribution channel buyers may decrease because of the Internet. *Buyer channel intermediaries* are the wholesalers, distributors, and retailers who serve as intermediaries between manufacturers and end users. In some industries, they are dominated by powerful players that control who gains access to the latest goods or the best merchandise. The Internet and wireless communications, however, make it much easier and less expensive for businesses to reach customers directly. Thus, the Internet may increase the power of incumbent firms relative to that of traditional buyer channels. Strategy Spotlight 2.5 illustrates some of the changes brought on by the Internet that have affected the legal services industry.

The Bargaining Power of Suppliers

The Bargaining Power of Suppliers Use of the Internet and digital technologies to speed up and streamline the process of acquiring supplies is already benefiting many sectors of the economy. But the net effect of the Internet on supplier power will depend on the nature of competition in a given industry. As with buyer power, the extent to which the Internet is a benefit or a detriment also hinges on the supplier's position along the supply chain.

The role of suppliers involves providing products or services to other businesses. The term “B2B”—that is, business-to-business—often refers to businesses that supply or sell to other businesses. The effect of the Internet on the bargaining power of suppliers is a double-edged sword. On the one hand, suppliers may find it difficult to hold on to customers because buyers can do comparative shopping and price negotiations so much faster on the Internet.

On the other hand, several factors may also contribute to stronger supplier power. First, the growth of new web-based business may create more downstream outlets for suppliers to sell to. Second, suppliers may be able to create web-based purchasing arrangements that make purchasing easier and discourage their customers from switching. Online procurement systems directly link suppliers and customers, reducing transaction costs and paperwork.⁷¹ Third, the use of proprietary software that links buyers to a supplier's website may create a rapid, low-cost ordering capability that discourages the buyer from seeking other sources of supply. Amazon.com, for example, created and patented One-Click purchasing technology that speeds up the ordering process for customers who enroll in the service.⁷²

Finally, suppliers will have greater power to the extent that they can reach end users directly without intermediaries. Previously, suppliers often had to work through intermediaries who brought their products or services to market for a fee. But a process known as *disintermediation* is removing the organizations or business process layers responsible for intermediary steps in the value chain of many industries.⁷³ Just as the Internet is eliminating some business functions, it is creating an opening for new functions. These new activities are entering the value chain by a process known as *reintermediation*—the introduction of new types of intermediaries. Many of these new functions are affecting traditional supply chains. For example, delivery services are enjoying a boom because of the Internet. Many more consumers are choosing to have products delivered to their door rather than going out to pick them up.

The Threat of Substitutes

The Threat of Substitutes Along with traditional marketplaces, the Internet has created a new marketplace and a new channel. In general, therefore, the threat of substitutes is heightened because the Internet introduces new ways to accomplish the same tasks.

Consumers will generally choose to use a product or service until a substitute that meets the same need

becomes available at a lower cost. The economies created by Internet technologies have led to the development of numerous substitutes for traditional ways of doing business.

Another example of substitution is in the realm of electronic storage. With expanded desktop computing, the need to store information electronically has increased dramatically. Until recently, the trend has been to create increasingly larger desktop storage capabilities and techniques for compressing information that create storage efficiencies. But a viable substitute has emerged: storing information digitally on the Internet. Companies such as Dropbox and Amazon web services are providing web-based storage that firms can access simply by leasing space online. Since these storage places are virtual, they can be accessed anywhere the web can be accessed. Travelers can access important documents and files without transporting them physically from place to place.

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2.5 STRATEGY SPOTLIGHT

BUYER POWER IN LEGAL SERVICES: THE ROLE OF THE INTERNET

The \$260 billion U.S. legal services industry, which includes about 180,000 firms, historically was a classic example of an industry that leaves buyers at a bargaining disadvantage. One of the key reasons for the strong bargaining position of law firms is high information asymmetry between lawyers and consumers, meaning that highly trained and experienced legal professionals know more about legal matters than the average consumer of legal services.

The Internet provides an excellent example of how unequal bargaining power can be reduced by decreasing information asymmetry. A new class of Internet legal services providers tries to accomplish just that and is challenging traditional law services along the way. For instance, *LawPivot.com*, a recent start-up backed by Google Ventures and cofounded by a former top Apple Inc. lawyer, allows consumers to interact with lawyers on a social networking site. This service allows customers to get a better picture of a lawyer's legal skills before opening their wallets. As a result, information asymmetry between lawyers and consumers is reduced and customers find themselves in a better bargaining position. Another example is LegalZoom.com, a service that helps consumers to create legal documents. Customers familiar with LegalZoom.com may use their knowledge of the time and effort required to create legal documents to challenge a lawyer's fees for custom-crafted legal documents.

Sources: Jacobs, D. L. 2011. Google takes aim at lawyers. *Forbes*, August 8: np; Anonymous. 2011. Alternative law firms: Bargain briefs. *The Economist*, August 13: 64; and Anonymous. 2014. Legal services industry profile. *First Research*, August 25: np.

The Intensity of Competitive Rivalry

The Intensity of Competitive Rivalry Because the Internet creates more tools and means for competing, rivalry among competitors is likely to be more intense. Only those competitors that can use digital technologies and the web to give themselves a distinct image, create unique product offerings, or provide “faster, smarter, cheaper” services are likely to capture greater profitability with the new technology.

Rivalry is more intense when switching costs are low and product or service differentiation is minimized. Because the Internet makes it possible to shop around, it has “commoditized” products that might previously have been regarded as rare or unique. Since the Internet reduces the importance of location, products that previously had to be sought out in geographically distant outlets are now readily available online. This makes competitors in cyberspace seem more equally balanced, thus intensifying rivalry.

The problem is made worse for marketers by the presence of shopping robots (“bots”) and infomediaries that search the web for the best possible prices. Consumer websites like mySimon seek out all the web locations that sell similar products and provide price comparisons.⁷⁴ Obviously, this focuses the consumer exclusively on price. Some shopping infomediaries, such as CNET, not only search for the lowest prices on many different products but also rank the customer service quality of different sites that sell similarly priced items.⁷⁵ Such infomediary services are good for consumers because they give them the chance to compare services as well as price. For businesses, however, they increase rivalry by consolidating the marketing message that consumers use to make a purchase decision into a few key pieces of information over which the selling company has little control.

Using Industry Analysis: A Few Caveats

For industry analysis to be valuable, a company must collect and evaluate a wide variety of information. As the trend toward globalization accelerates, information on foreign markets as well as on a wider variety of competitors, suppliers, customers, substitutes, and potential new entrants becomes more critical. Industry analysis helps a firm not only to evaluate the profit potential of an industry but also to consider various ways to strengthen its position vis-à-vis the five forces. However, we'd like to address a few caveats.

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First, *managers must not always avoid low-profit industries (or low-profit segments in profitable industries)*.⁷⁶ Such industries can still yield high returns for some players who pursue sound strategies. As examples, consider Paychex, a payroll-processing company, and WellPoint Health Network, a huge health care insurer.⁷⁷

Paychex, with \$2 billion in revenues, became successful by serving small businesses. Existing firms had ignored them because they assumed that such businesses could not afford the service. When Paychex's founder, Tom Golisano, failed to convince his bosses at Electronic Accounting Systems that they were missing a great opportunity, he launched the firm. It now serves nearly 600,000 clients in the United States and Germany. Paychex's after-tax-return on sales is a stunning 25 percent.

In 1986, WellPoint Health Network (when it was known as Blue Cross of California) suffered a loss of \$160 million. That year, Leonard Schaeffer became CEO and challenged the conventional wisdom that individuals and small firms were money losers. (This was certainly “heresy” at the time—the firm was losing \$5 million a year insuring 65,000 individuals!) However, by the early 1990s, the health insurer was leading the industry in profitability. The firm has continued to grow and outperform its rivals even during economic downturns. By 2012, its revenues and profits were \$61 billion and \$2.5 billion, respectively.

Second, five-forces analysis implicitly *assumes a zero-sum game, determining how a firm can enhance its position relative to the forces*. Yet such an approach can often be shortsighted; that is, it can overlook the many potential benefits of developing constructive win–win relationships with suppliers and customers. Establishing long-term mutually beneficial relationships with suppliers improves a firm's ability to implement just-in-time (JIT) inventory systems, which let it manage inventories better and respond quickly to market demands. A recent study found that if a company exploits its powerful position against a supplier, that action may come back to haunt the company.⁷⁸ Consider, for example, General Motors' heavy-handed dealings with its suppliers.⁷⁹

zero-sum game a situation in which multiple players interact, and winners win only by taking from other players.

In 2014, GM was already locked in a public relations nightmare as a deadly ignition defect triggered the recall of over 2.5 million vehicles.⁸⁰ At the same time, it was faced with another perception problem: poor supplier relations. GM is now considered the worst big automaker to deal with, according to a new survey of top suppliers in the car industry in the United States.

The annual survey, conducted by the automotive consultant group, Planning Perspectives Inc., asks the industry's biggest suppliers to rate the relationships with the six automakers that account for more than 85 percent of all cars and light trucks in the U.S. Those so-called “Tier 1” suppliers say GM is their least favorite big customer—less popular than even Chrysler, the unit of Fiat Chrysler Automobiles that had “earned” the dubious distinction since 2008.

The suppliers gave GM low marks on all kinds of measures, including its overall trustworthiness, its communication skills, and its protection of intellectual property. The suppliers also said that GM was the automaker least likely to allow them to raise prices to recoup unexpected materials cost increases. In return, parts executives have said they tend to bring hot new technology to other carmakers first—certainly something that makes it more difficult for GM to compete in this hotly contested industry.

Third, the five-forces analysis also has been criticized for *being essentially a static analysis*. External forces as well as strategies of individual firms are continually changing the structure of all industries. The search for a dynamic theory of strategy has led to greater use of game theory in industrial organization economics research and strategy research.

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Based on game-theoretic considerations, Brandenburger and Nalebuff recently introduced the concept of the value net,⁸¹ which in many ways is an extension of the five-forces analysis. It is illustrated in Exhibit 2.6. The value net represents all the players in the game and analyzes how their interactions affect a firm's ability to generate and appropriate value. The vertical dimension of the net includes suppliers and customers. The firm has direct transactions with them. On the horizontal dimension are substitutes and complements, players with whom a firm interacts but may not necessarily transact. The concept of complementors is perhaps the single most important contribution of value net analysis and is explained in more detail below.

EXHIBIT 2.6 The Value Net

The Value Net

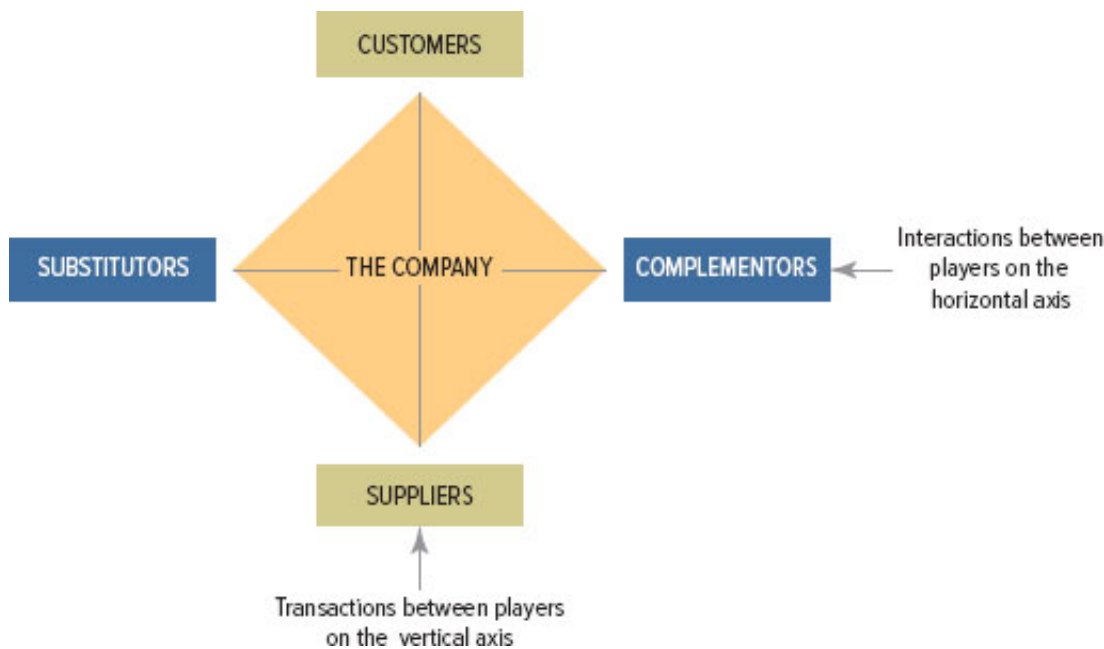


EXHIBIT 2.6

The Value Net The Value Net

Sources: Adapted from “The Right Game: Use Game Theory Shape Strategy,” by A. Brandenburger and B.J. Nalebuff, July-August 1995 Harvard Business Review.

Complements typically are products or services that have a potential impact on the value of a firm's own products or services. Those who produce complements are usually referred to as complementors.⁸² Powerful hardware is of no value to a user unless there is software that runs on it. Similarly, new and better software is possible only if the hardware on which it can be run is available. This is equally true in the video game industry, where the sales of game consoles and video games complement each other. Nintendo's success in the early 1990s was a result of its ability to manage its relationship with its complementors. Nintendo built a security chip into the hardware and then licensed the right to develop games to outside firms. These firms paid a royalty to Nintendo for each copy of the game sold. The royalty revenue enabled Nintendo to sell game consoles at close to their cost, thereby increasing their market share, which, in turn, caused more games to be sold and more royalties to be generated.⁸³

complements products or services that have an impact on the value of a firm's products or services.

Despite efforts to create win-win scenarios, conflict among complementors is inevitable.⁸⁴ After all, it is naive to expect that even the closest of partners will do you the favor of abandoning their own interests. And even the most successful partnerships are seldom trouble-free. Power is a factor that comes into play as we see in Strategy Spotlight 2.6 with the example of Apple's iPod—an enormously successful product.

We would like to close this section with some recent insights from Michael Porter, the originator of the five-forces analysis.⁸⁵ He addresses two critical issues in conducting a good industry analysis, which will yield an improved understanding of the root causes of profitability: (1) choosing the appropriate time frame and (2) a rigorous quantification of the five forces.

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- ***Good industry analysis looks rigorously at the structural underpinnings of profitability. A first step is to understand the time horizon.*** One of the essential tasks in industry analysis is to distinguish short-term fluctuations from structural changes. A good guideline for the appropriate time horizon is the full business cycle for the particular industry. For most industries, a three- to five-year horizon is

appropriate. However, for some industries with long lead times, such as mining, the appropriate horizon may be a decade or more. It is average profitability over this period, not profitability in any particular year, which should be the focus of analysis.

- ***The point of industry analysis is not to declare the industry attractive or unattractive but to understand the underpinnings of competition and the root causes of profitability.*** As much as possible, analysts should look at industry structure quantitatively, rather than be satisfied with lists of qualitative factors. Many elements of five forces can be quantified: the percentage of the buyer's total cost accounted for by the industry's product (to understand buyer price sensitivity); the percentage of industry sales required to fill a plant or operate a logistical network to efficient scale (to help assess barriers to entry); and the buyer's switching cost (determining the inducement an entrant or rival must offer customers).

2.6 STRATEGY SPOTLIGHT

APPLE'S IPOD: RELATIONSHIPS WITH ITS COMPLEMENTORS

In 2002, Steve Jobs began his campaign to cajole the major music companies into selling tracks to iPod users through the iTunes Music store, an online retail site. Most industry executives, after being burned by illegal file-sharing services like Napster and Kazaa, just wanted digital music to disappear. However, Jobs's passionate vision persuaded them to climb on board. He promised to reduce the risks that they faced by offering safeguards against piracy, as well as a hip product (iPod and iPad touch) that would drive sales.

However, Apple had a much stronger bargaining position when its contracts with the music companies came up for renewal in April 2005. By then, iTunes had captured 80 percent of the market for legal downloads. The music companies, which were receiving between 60 and 70 cents per download, wanted more. Their reasoning: If the iTunes Music store would only charge \$1.50 or \$2.00 per track, they could double or triple their revenues and profits. Since Jobs knew that he could sell more iPods if the music was cheap, he was determined to keep the price of a download at 99 cents and to maintain Apple's margins. Given iTunes' dominant position, the music companies had little choice but to relent.

Apple's foray into music has been tremendously successful. Since the iPod's introduction in 2001, Apple has sold over 300 million iPod units worldwide. And iTunes software and services are still going strong, increasing to \$16 billion in 2013—a 71 percent increase over 2011! Having won the music market, Apple's success elsewhere has come even more quickly. Apple's millions of users create powerful network effects, exerting a strong gravitational pull on content providers to participate in the iTunes ecosystem. By mid-2013, the iTunes store had captured more than 65 percent of the market for digital movies and television programming—a market largely created by Apple.

Sources: Downes, L. & Nunes, P. 2014. *Big bang disruption*. New York: Penguin; Reisinger, D. 2012. why the iPod (yes, the iPod) still matters. *Fortune*, October 8: 79; Hesseldahl, A. 2008. now that we all have iPods. *BusinessWeek*, December 15: 36; Apple Computer Inc. 10-K, 2010; 2012 Apple, Inc. Annual Report; and Yoffie, D. B. & Kwak, M. 2006. with friends like these: the art of managing complementors. *Harvard Business Review*, 84(9): 88–98.

Strategic Groups within Industries

LO2.7

The concept of strategic groups and their strategy and performance implications.

In an industry analysis, two assumptions are unassailable: (1) No two firms are totally different, and (2) no two firms are exactly the same. The issue becomes one of identifying groups of firms that are more similar to each other than firms that are not, otherwise known as strategic groups.⁸⁶ This is important because rivalry tends to be greater among firms that are alike. Strategic groups are clusters of firms that share similar strategies. After all, is Kmart more concerned about Nordstrom or Walmart? Is Mercedes more concerned about Hyundai or BMW? The answers are straightforward.⁸⁷

Strategic groups clusters of firms that share similar strategies.

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These examples are not meant to trivialize the strategic groups concept.⁸⁸ Classifying an industry into strategic groups involves judgment. If it is useful as an analytical tool, we must exercise caution in deciding what dimensions to use to map these firms. Dimensions include breadth of product and geographic scope, price/quality, degree of vertical integration, type of distribution (e.g., dealers, mass merchandisers, private label), and so on. Dimensions should also be selected to reflect the variety of strategic combinations in an industry. For example, if all firms in an industry have roughly the same level of product differentiation (or R&D intensity), this would not be a good dimension to select.

What value is the strategic groups concept as an analytical tool? *First, strategic groupings help a firm identify barriers to mobility that protect a group from attacks by other groups.*⁸⁹ Mobility barriers are factors that deter the movement of firms from one strategic position to another. For example, in the chainsaw industry, the major barriers protecting the high-quality/dealer-oriented group are technology, brand image, and an established network of servicing dealers.

The second value of strategic grouping is that it *helps a firm identify groups whose competitive position may be marginal or tenuous*. We may anticipate that these competitors may exit the industry or try to move into another group. In recent years in the retail department store industry, firms such as JCPenney and Sears have experienced extremely difficult times because they were stuck in the middle, neither an aggressive discount player like Walmart nor a prestigious upscale player like Neiman Marcus.

Third, strategic groupings *help chart the future directions of firms' strategies*. Arrows emanating from each strategic group can represent the direction in which the group (or a firm within the group) seems to be moving. If all strategic groups are moving in a similar direction, this could indicate a high degree of future volatility and intensity of competition. In the automobile industry, for example, the competition in the minivan and sport utility segments has intensified in recent years as many firms have entered those product segments.

Fourth, strategic groups are *helpful in thinking through the implications of each industry trend for the strategic group as a whole*. Is the trend decreasing the viability of a group? If so, in what direction should the strategic group move? Is the trend increasing or decreasing entry barriers? Will the trend decrease the ability of one group to separate itself from other groups? Such analysis can help in making predictions about industry evolution. A sharp increase in interest rates, for example, tends to have less impact on providers of higher-priced goods (e.g., Porsches) than on providers of lower-priced goods (e.g., Chevrolet Cobalt), whose customer base is much more price-sensitive.

Exhibit 2.7 provides a strategic grouping of the worldwide automobile industry.⁹⁰ The firms in each group are representative; not all firms are included in the mapping. We have identified four strategic groups. In the top left-hand corner are high-end luxury automakers that focus on a very narrow product market. Most of the cars produced by the members of this group cost well over \$100,000. Some cost over twice that amount. The 2015 Ferrari California T starts at \$201,940, and the 2015 Lamborghini Huracan will set you back \$237,250 (in

case you were wondering how to spend your employment signing bonus). Players in this market have a very exclusive clientele and face little rivalry from other strategic groups. At the other extreme, in the lower left-hand corner is a strategic group that has low-price/quality attributes and targets a narrow market. These players, Hyundai and Kia, limit competition from other strategic groups by pricing their products very low. The third group (near the middle) consists of firms high in product pricing/quality and average in their product-line breadth. The final group (at the far right) consists of firms with a broad range of products and multiple price points. these firms have entries that compete at both the lower end of the market (e.g., the Ford Focus) and the higher end (e.g., Chevrolet Corvette).

EXHIBIT 2.7 The World Automobile Industry: Strategic Groups

The World Automobile Industry: Strategic Groups

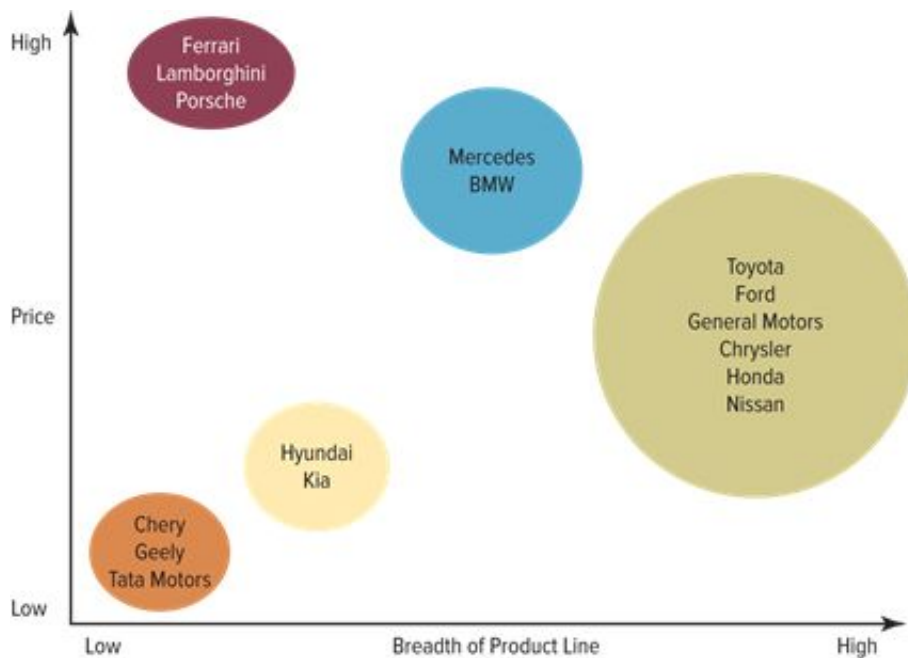


EXHIBIT 2.7

The World Automobile Industry: Strategic Groups The World Automobile Industry: Strategic Groups

Note: Members of each strategic group are not exhaustive, only illustrative.

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The auto market has been very dynamic and competition has intensified in recent years.⁹¹ For example, some players are going more upscale with their product offerings. In 2009, Hyundai introduced its Genesis, starting at \$33,000. This brings Hyundai into direct competition with entries from other strategic groups such as Toyota's Camry and Honda's Accord. And, in 2010, Hyundai introduced the Equus model. It was priced at about \$60,000 to compete directly with the Lexus 460 on price. To further intensify competition, some upscale brands are increasingly entering lower-priced segments. In 2014, Audi introduced the Q3 SUV at a base price of only \$32,500. And BMW, with its 1-series, is another well-known example. Such cars, priced in the low \$30,000s, compete more directly with products from broad-line manufacturers like Ford, General Motors, and Toyota. This suggests that members of a strategic group can overcome mobility barriers and migrate to other groups that they find attractive if they are willing to commit time and resources.

Our discussion would not be complete, of course, without paying some attention to recent entries in the automobile industry that will likely lead to the formation of a new strategic group—placed at the bottom left corner of the grid in Exhibit 2.7. three firms—China's Zhejiang Geely Holding Company, China's Chery Automobile Company, and India's tata Motors—have introduced models that bring new meaning to the term

“subcompact.”⁹² Let's take a look at these econoboxes.

Chery's 2013 QQ model sells for between \$6,083 and \$8,170 in the Chinese market and sports horsepower in the range of only 51 to 74. Geely's best-selling four-door sedan, the Free Cruiser, retails from \$5,440 to \$7,046. The firm has gone more upscale with some offerings, such as the GX7, a sports utility vehicle with a price starting at \$14,910.

For low price-points, India's Tata Motors has everyone beat by the proverbial mile. In January 2008, it introduced the Nano as the “world's Cheapest Car,” with an astonishing retail price of only \$2,500. It is a four-door, five-seat hatchback that gets 54 miles to the gallon (but this economy originally came with a 30 horsepower motor). Initially, it was a big hit in India. However, after sales peaked at about 80,000 units in 2011–2012, they crashed to only 21,000 units in 2013–2014. As noted by Girish Wagh, the man behind the Nano, “People started looking at Nano not as a low-cost innovation, but as a cheap car. This, among other factors, also hurt the chances.” Needless to say, Tata has made many attempts to make the car more upscale, with a correspondingly higher price.

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Not surprisingly, some automakers have recently entered the Indian market with more desirable offerings. Several have offerings that are called compact sedans, but they are actually hatchbacks with a tiny trunk tacked on. These models include Suzuki's Dzire, Honda's Amaze, and Hyundai's Xcent. Prices start at around \$8,000, and with the added cachet of a sedan silhouette that adds only a few hundred dollars, these models have become very popular with Indian buyers. This niche is one of the few car segments that soared, while the country's overall car market shrunk.

ISSUE FOR DEBATE

Should Large Firms Further Delay Payments to their Suppliers?

In 2013, Mondelez International, the snack and food company recently spun off by Kraft Foods, sent a letter to its suppliers explaining its new policy: 120 days before paying a bill is now standard operating policy. It appears that this is a growing trend—companies withholding payment to suppliers after a service is performed or a product delivered. Procter & Gamble drew complaints when it started negotiating with suppliers to extend the delay in payments to 75 days, up from 45 days. Unilever is considering a similar move, and Merck has broached the subject of waiting 90 days to pay its vendors and suppliers.

One can easily understand why a large company would be tempted to hold off paying its suppliers. Holding onto millions—or even billions—of dollars for an extra month or two (or four) can free up cash to invest or generate whatever interest it can gain. In an environment in which businesses are continually scrambling to boost earnings in an uncertain economic climate, it's an easy way to hike profits.

Bill Dunkelberg, chief economist for the National Federation of Independent Businesses, has a different perspective: “It's mean. It's a pain in the butt and costly for small firms that are having this happen to them.” Small companies are often very vulnerable because one large customer may make up the bulk of a small firm's sales, leaving it with little choice but to accede to the demands of a giant company—effectively financing the customer for 120 days.

In response to an inquiry by Becky Quick, a *Fortune* writer, a Mondelez spokesman emailed a statement, reading in part: “Extending our payment terms allows us to better align with industry (norms) and make sure we compete on fair grounds, while simultaneously improving transparency and predictability of payment processes.” However, it may appear ironic that the company tailors its terms so that its customers are penalized if they don't pay for confections within 15 days of receipt and for snacks within 25 days, according

to an industry insider.

Discussion Questions

1. Should Mondelez and other companies follow the practice of lengthening payment terms with their suppliers? why? or why not?
2. Do you feel that this practice can raise ethical issues?
3. What actions can suppliers take to respond to the lengthening of the payment terms?

Source: Quick, B. 2013. A snack maker's unsavory business practices. *Fortune*, September 2: 54.