

Economics of Strategy

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Chapter 10

Industry Analysis

Slide show prepared by

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Industry Analysis

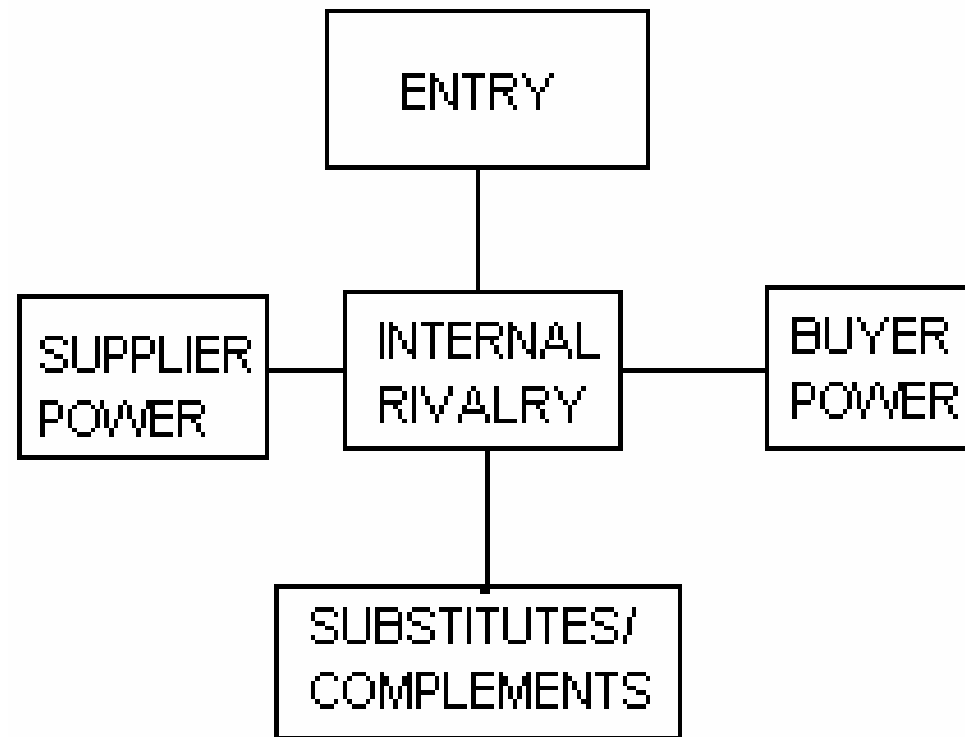
Industry analysis facilitates

- assessment of industry and firm performance
- identification of factors that affect performance
- determination of the effect of changes in the business environment on performance
- identification of opportunities and threats

Porter's Five Forces Framework

- Michael Porter has developed a framework called five forces framework to identify the economic forces that affect industry profits
- The five forces are
 - Internal rivalry
 - Entry
 - Substitutes and complements
 - Supplier power
 - Buyer power

The Five Forces Framework



Internal Rivalry

- Internal rivalry is the competition for market share among the firms in the industry
- Competition could be on price or some non-price dimension
- Price Competition erodes the price cost margin and profitability

Internal Rivalry

- Competition on non-price dimension can drive up costs
- To the extent customers are willing to pay a higher price for improvements in the non-price dimensions, non-price competition does not erode profits as severely as price competition

Internal Rivalry: Conditions that Heat up Price Competition

Some of the conditions that allow the price competition to heat up are

- Presence of many sellers
- Some firms' cost advantage over others
- Excess capacity
- Undifferentiated products/Low switching costs
- Easy observability of prices and sale terms

Internal Rivalry: Conditions that Heat up Price Competition (Cont.)

- Inability to adjust prices quickly
- Large and infrequent sales orders
- Absence of “facilitating practices”
- Absence of a history of cooperative pricing
- Strong exit barriers

Entry

- Entry hurts the incumbents in two different ways
- Entry cuts into the incumbents' market share
- Entry intensifies internal rivalry and leads to a decline in price cost margin

Factors that Affect the Threat of Entry

- Minimum efficient scale relative to the size of the market
- Brand loyalty of consumers and value placed by consumers on reputation
- Entrants' access to critical resources such as raw material, technical know how and distribution network
- Government policies that favor the incumbents

Factors that Affect the Threat of Entry

- Steepness of the learning curve
- Network externalities that give the incumbents the benefit of a large installed base
- Incumbents reputation regarding post-entry competitive behavior

Substitutes and Complements

- Availability of substitutes erode the demand for the industry's output
- Complements boost industry demand
- When the price elasticity of demand is large, pressure from substitutes will be significant
- Change in demand can in turn affect internal rivalry and entry/exit

Supplier Power

Suppliers can erode the profitability of downstream firms

- If the upstream industry is concentrated
- If the customers are locked into the relationship through relationship specific assets

Supplier Power

- Supplier power should not be confused with the importance of the input for the downstream firms
- Even when an important input is involved, fierce price competition among the upstream firms can weaken supplier power

Assessing Supplier Power

- The factors that determine supplier power
 - Competitiveness of the input market
 - Relative concentration of upstream and downstream firms
 - Purchase volume by downstream firms
 - Extent of relationship specific investments
 - Availability of substitute inputs
 - Threat of forward integration by suppliers
 - Suppliers' ability to price discriminate

Assessing Buyer Power

- Factors that determine buyer power are analogous to those that determine supplier power
- Even when there is no buyer power, willingness to shop for the best price can create internal rivalry among sellers and make the market price competitive

Some Strategies to Cope with the Five Forces

- Firms can position themselves to outperform the rivals by developing a cost advantage or a differentiation advantage
- Firms can seek an industry segment where the five forces are less severe

Some Strategies to Cope with the Five Forces

- Firms can try to change the five forces
 - By reducing internal rivalry by increasing the switching costs,
 - By adopting entry deterring strategies or
 - By reducing supplier/buyer power through tapered vertical integration

“Five Forces” and “Value Net”

- The five forces framework tends to view other firms - competitors, suppliers or buyers - as threats to profitability
- In the Value Net model of Brandenberger and Nalebuff, interactions between firms can be positive or negative

Examples of Cooperative Interactions Among Firms

- Firms cooperate in setting industry standards that facilitate industry growth
- Firms cooperate in lobbying for favorable regulation or legislation
- Firms cooperate with their suppliers to improve product quality and thus boost demand

More Examples of Cooperative Interactions Among Firms

- Firms cooperate with their suppliers to improve productive efficiency
- Firms cooperate with buyers/suppliers to improve inventory management

The Value Net Concept

- The value net consists of
 - Suppliers
 - Customers
 - Competitors and
 - Complementors (producers of complementary goods and services)
- Considers both threats and opportunities posed by the five forces

Value Net Illustration: DVD

- When DVD was introduced, sales were lack luster and DIVX was a major threat
- Then manufacturers cut prices on some models and advertised heavily
- Other members of the value net chipped in
 - Movie studios released popular titles in DVD format and priced them moderately
 - Retailers promoted the DVD hardware and software

Five Forces Analysis of Chicago Hospitals: Market Definition

- Product market is the market for acute medical services
- Competition among hospitals is local with each metropolitan area working as a distinct market

Five Forces Analysis of Chicago Hospitals: Internal Rivalry

- Concentration as measured by Hefindahl index has gone up slightly over the last 20 years
- Twenty years ago most hospitals were independent while today many of them belong to systems
- Cross price elasticities were low as long as patients had traditional insurance

Five Forces Analysis of Chicago Hospitals: Internal Rivalry

- With the expansion of managed care, insurers began to replace patients and their doctors as “customers”
- Insurers were less brand loyal than patients and were tough negotiators
- Contract negotiations were secret and contracting was lumpy causing price competition among hospitals

Five Forces Analysis of Chicago Hospitals: Entry

- State regulatory restrictions on new hospital construction that provided a structural barrier to entry have been relaxed
- Other barriers to entry continue to exist
 - Capital intensive nature of hospitals
 - Difficulties in making brand loyal customers switch
 - Difficulties in establishing a base of medical staff that admit patients

Five Forces Analysis of Chicago Hospitals: Substitutes/Complements

- Due to technological changes, substitutes for hospital services have emerged
- Insurers have provided inducements for patients to seek outpatient services
- Economies of scope have allowed hospitals to expand into outpatient services

Five Forces Analysis of Chicago Hospitals: Supplier Power

- Specialized medical personnel do not have substitutes due to their specialized skills and licensing requirements
- Firms that supply complex equipment and supplies have substantial supplier power
- Those who supply commodity products like surgical gloves do not have any supplier power

Five Forces Analysis of Chicago Hospitals: Buyer Power

- When most patients are insured, patients and doctors do not wield purchasing power
- Insurers who wield purchasing power were largely passive two decades ago
- Buyer power has been on the increase as managed care insurers continuously seek to cut costs

Five Forces Analysis of Chicago Hospitals: Summary

<i>Force</i>	<i>Threat to Profits 1980</i>	<i>Threat to Profits: Today</i>
Internal Rivalry	Low	High but falling
Entry	Low	Medium but growing
Substitutes and Complements	Medium	High
Supplier Power	Medium	Medium
Buyer Power	Low	Medium

Commercial Airframe Manufacturing: Market Definition

- Analysis limited to commercial aviation
- Boeing and Airbus compete globally
- Other fringe players in aircraft with capacity less than 100 seats

Commercial Airframe Manufacturing: Internal Rivalry

- Airbus is younger, established by an European consortium (Great Britain, France, and Germany)
- Little product differentiation
- Airlines have developed loyalties
- Stable market shares and reduced incentive for price wars

Commercial Airframe Manufacturing: Barriers to Entry

- Huge development costs
- Buyer reluctance to buy from startups
- Leasing economies
- Customer loyalty to current suppliers

Commercial Airframe Manufacturing: Substitutes and Complements

- Small plane manufacturers can cut into demand for Boeing and Airbus
- Other forms of transportation could be substitutes (High speed rail)

Commercial Airframe Manufacturing: Supplier Power

- Boeing and Airbus do not have the upper hand in dealing with jet engine manufacturers
- Other part suppliers also deal directly with airlines
- Unionized labor has significant power

Commercial Airframe Manufacturing: Buyer Power

- Two kinds of buyers
 - Airlines
 - Leasing companies
- Each order could be of the order of 15% of annual sales revenue
- Buyers may cancel orders during economic downturns

Commercial Airframe Manufacturing: Summary

<i>Force</i>	<i>Threat to Profits</i>
Entry	Low
Internal rivalry	Low to Medium
Supplier Power	Medium
Buyer Power	Medium
Substitutes/Complements	Medium to High

Hawaiian Coffee: Market Definition

- Hawaiian coffee is a specialty coffee for which less expensive coffees are not good substitutes
- Most of the Hawaiian coffee is purchased in the United States
- Geographic isolation of Hawaii places all the growers in the same submarket

Hawaiian Coffee: Internal Rivalry

- There has been little price competition among growers
- Kona growers have worked through cooperatives who strive preserve the value of “Kona” brand image
- Non-Kona growers have avoided price competition and have filled the gaps in price/quality continuum

Hawaiian Coffee: Entry

- Entry is difficult due to structural barriers such as limited availability of desirable land and required fixed investment
- Due to the time and expense of developing mature trees, exit of growing capacity is unlikely

Hawaiian Coffee: Substitutes/Complements

- Consumers of Hawaiian coffee are highly price insensitive and very brand loyal
- Complements for coffee when people eat out are pastries in the morning and desserts in the evening
- Hawaiian vacations could be another complement since vacations can expose new customers to the Hawaiian flavor

Hawaiian Coffee: Buyer Power

- Buyers want to maintain good relations with the suppliers to maintain access to good quality Hawaiian beans
- There is some danger that buyers may steer their customers to less expensive coffees in order to earn better margins

Five Forces Analysis of Hawaiian Coffee : Summary

<i>Force</i>	<i>Threat to Profits</i>
Internal Rivalry	Low to Medium
Entry	Low
Substitutes/Complements	Medium
Buyer Power	Medium
Supplier Power	Low