

Strategy 1 Strategy Introduction

- > Background
- > Porter's 5 Forces Model
- > Class Activity
- > Key Takeaways

What is an Industry?

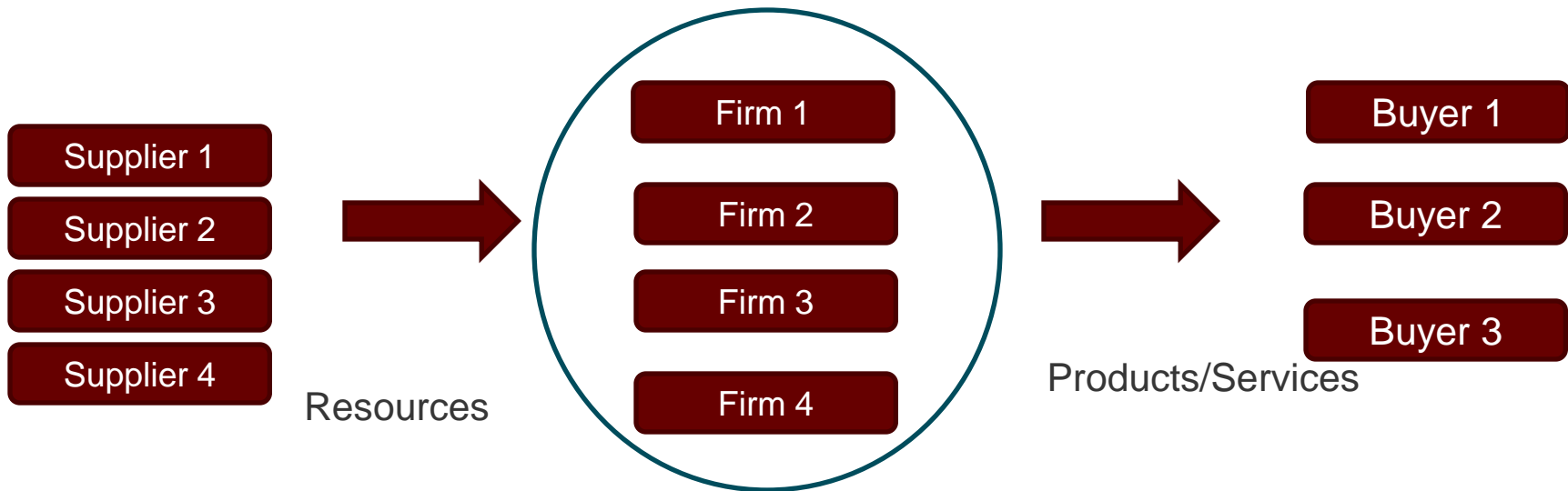


But why these concepts?



- > OC and WP bound our economy
- > For now, assume anything outside of this is outside our economy
- > Total Value created = $WP - OC$

What is an Industry? For now....



- > An industry may be defined as an organized economic activity concerned with the output of a specified good or service (Websters definition)
- > **For our purposes and in common lingo it can also mean a group of firms offering similar products competing for the same set of customers using roughly similar raw materials.**

Why do we care?



Why do we care about Industry?

Two Reasons

- > Industry Analysis is an important constituent of your Business Plan...Good enough reason...
 - > You will be expected to discuss the industry incumbents and Porter's forces to make your plan credible
- > Industry Structure defines the profitability of the **Average Firm** operating in that industry

Industry Analysis: A History of Thought

- > Rise of markets (1850s-1950s) [Experiences from intuition]
 - > M-form (Sloan and Barnard)
 - > WWII, scarcity and scientific enquiry

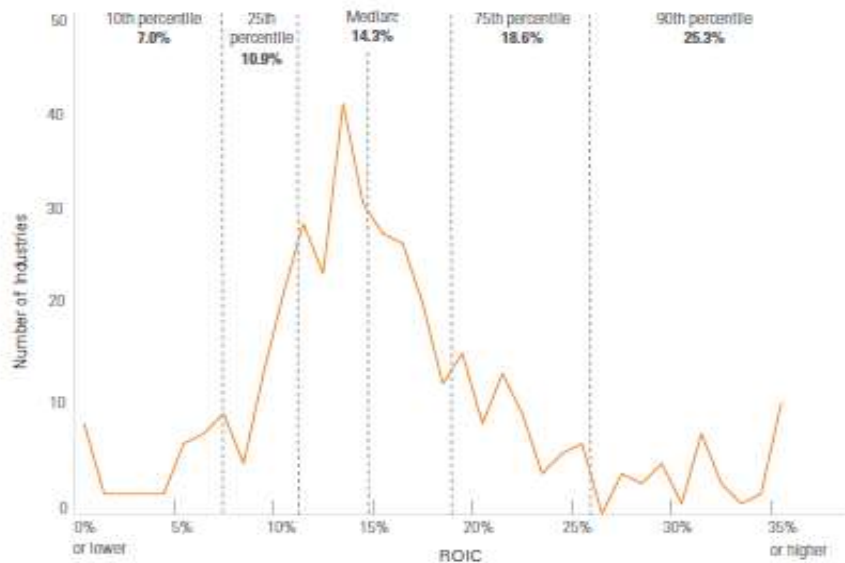
- > The Rise of Consultants (1960s-1970s) [Selling oversimplifications]
 - > BCG Matrix, GE (PIMS), McKinsey

- > 5 Forces Model (1980s-) [Framework for Industry Analysis]
 - > Corporate Strategy and Porter
 - > Which industries are attractive?



Industry Structure Affects Average Firm Profitability

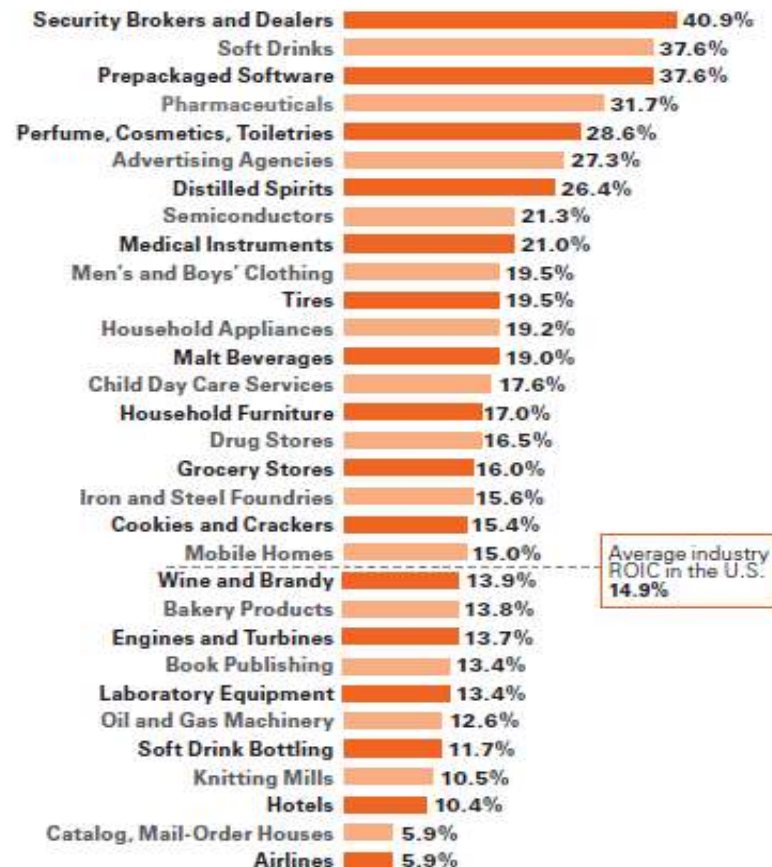
Average Return on Invested Capital in U.S. Industries, 1992–2006



Return on invested capital (ROIC) is the appropriate measure of profitability for strategy formulation, not to mention for equity investors. Return on sales or the growth rate of profits fail to account for the capital required to compete in the industry. Here, we utilize earnings before interest and taxes divided by average invested capital less excess cash as the measure of ROIC. This measure controls for idiosyncratic differences in capital structure and tax rates across companies and industries.

Source: Standard & Poor's, Compustat, and author's calculations

Profitability of Selected U.S. Industries
Average ROIC, 1992–2006



5 Forces Model

The Five Forces That Shape Industry Competition



How to analyze the 5 Forces?

- > Assess *strength* of each of the five competitive forces (Strong? Moderate? Weak?)
- > What are the factors that cause each force to be strong or weak?
- > Decide whether *overall competition (the combined effect of all five competitive forces)* is brutal, fierce, strong, normal/moderate, or weak

What increases Buyer bargaining power

- > They are large and purchase a sizable percentage of industry's product (Monopsony)
- > They buy in large quantities
- > They can integrate backward (Buy you out)
- > Industry's product is standardized
- > Their costs in switching to substitutes or other brands are low
- > They can purchase from several sellers
- > Product purchased does not save buyer money

What increases supplier bargaining power

- > Item makes up large portion of product costs, is crucial to production process, and/or significantly affects product quality
- > It is costly for buyers to switch suppliers
- > They have good reputations and growing demand
- > They can supply a component cheaper than industry members can make it themselves
- > They do not have to contend with substitutes
- > Buying firms are not important customers

What increases forces of rivalry?

- > Active jockeying for position among rivals and frequent launches of new offensives to gain sales and market share
- > Lots of firms that are relatively equal in size and capability
- > Spiraling downwards to commoditization
- > Industry conditions tempt some firms to go on the offensive to boost volume and market share
- > Customers have low costs in switching to rival brands

What increases threat of substitutes?

Understand alternate ways of meeting a need.

Can you think of examples in your industry?

Readily available

Attractively priced

Believed to have comparable or better performance features

Customer switching costs are low

What reduces new entry threat?

Entry Barriers: Do you have entry barriers in your industry?

- > Supply side scale economies
- > Demand side scale economies
- > Existence of strong learning/experience curve effects
- > Strong brand preferences and customer loyalty
- > Cost disadvantages independent of size
- > Difficulties in gaining access to distribution channels
- > Regulatory policies, tariffs, trade restrictions
- > Expected retaliation

Industry Types: Some terminology

	Competitive	Oligopoly	Monopoly
Competitors	Many	Few	None
Products	Substitutable	Differentiated	Non-substitutable
Value added	Negligible	Depends on strategy	High
Ease of entry	Easy	Tough	Very tough

Examples of Monopoly: Gamestop, De Beers, Monsanto

Examples of Duopoly: Soft drink (2), Operating systems?

Examples of Oligopoly: Movie studios (6), Food processing (3)

Examples of competitive markets: Stock exchange, Online auctions,
Free software, street vendors

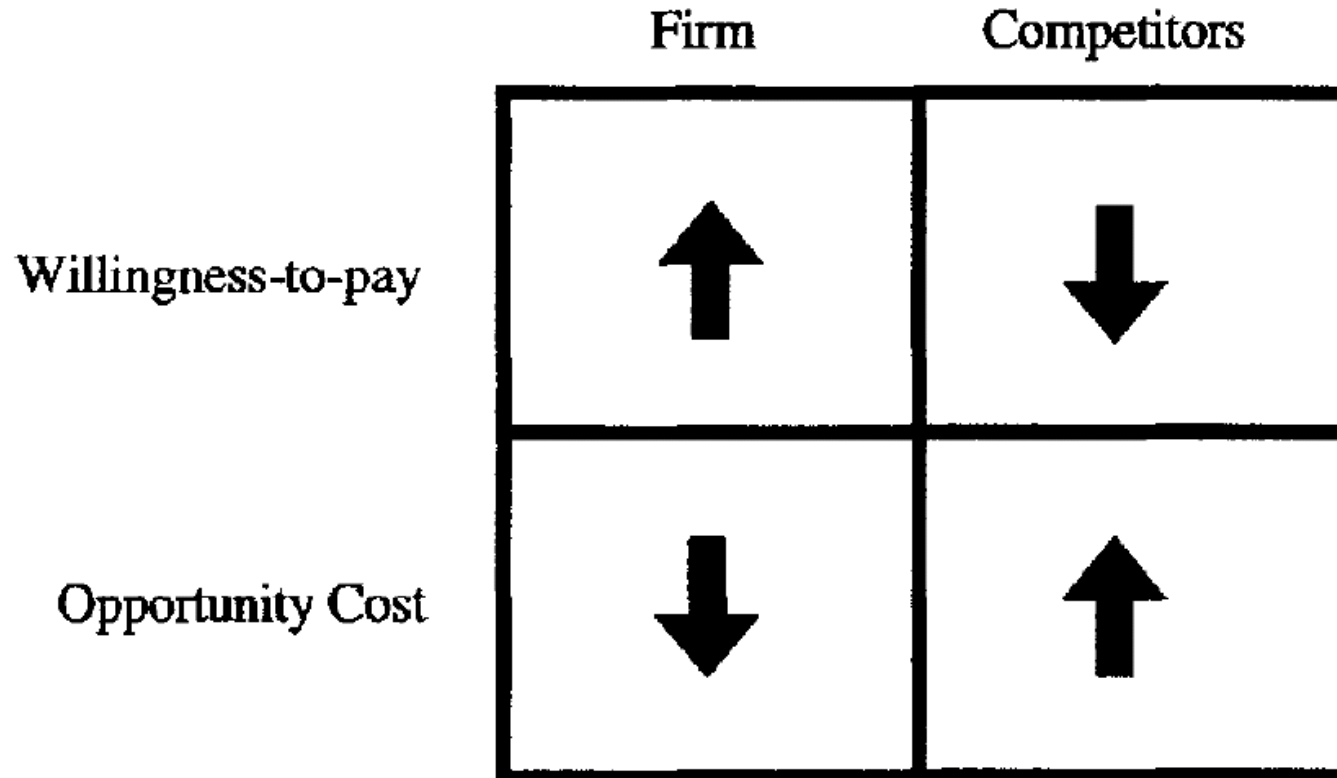
Class Activity: Applying the 5 Forces Model to Airlines

- > Divide into 6 groups
- > Argue for your claim giving reasons, evidence, qualifiers.

Analyze the automobile industry based on the 5 Forces Model.

1. Explain which forces are stronger and which are weak. Be prepared to justify your answer.
2. Based on the value framework suggest one generic strategy for this industry as an entrant. Make plausible claims about WP and OC and give reasons.

Creating value?



Value creation is creation of favorable asymmetry—the essence of entrepreneurship

Key Takeaways

- > Learn about the 5 Forces Model.
 - > Use in your business plan

- > Industry Structure affects **Average Firm Profitability**
 - > Compare industries and select the most profitable

- > Tools to back up your Industry Analysis
 - > Identifying trends and shifts in forces