

External Analysis

What is a Market?

A stack of US dollar bills, including \$100 and \$50 bills, is visible in the bottom left corner of the slide.

Strategy 5370
Dr. Smith

Why External Analysis?

External analysis allows firms to:

- Discover threats and opportunities
- See if above normal profits are likely in an industry
- Better understand the nature of competition in an industry
- Make more informed strategic choices

Industry Boundaries

- **Identifying industry competitors**
 - Products that provide value in functionally equivalent ways.
 - Firms that compete directly through changes in product value and price.
 - Firms that face common factors of economic interdependence in an industry.
- **Identifying substitute producers**
 - Products that are functionally different but provide similar value to buyers.

Defining Market Structure

Definition: Set of Suppliers & Demanders whose trading establishes the Price of a Good

Two sellers are in the same market if one seller's production and pricing decisions materially affect the price that the other seller may charge

Example: General Motors

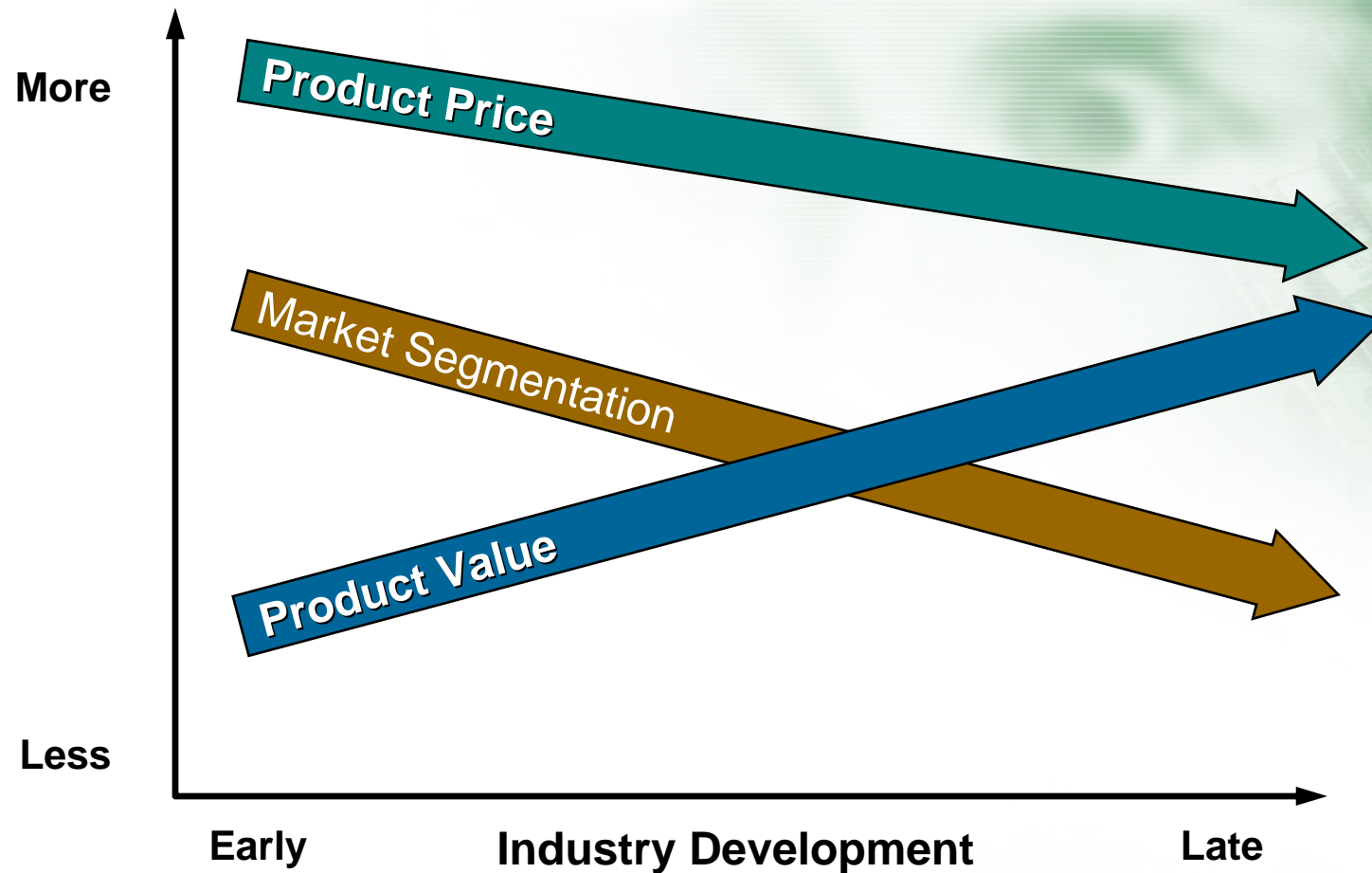
If **Toyota** were to lower the price and increase the production of its Camry line of family sedans, then **Honda** may have to adjust the price it charges for its family sedans.

... But, **Honda's** pricing of its motorcycle would probably not be affected.

How Are Industries Defined?

- **Market Segmentation**
 - Firms align their product lines with one or more customer oriented segments ... which could overlap
 - Segments are defined by customer preferences
 - Specialist firms: Compete and tailor their products that cater to a chosen segment
 - Generalist firms: Compete and tailor their product for all segments or a line of products tailored to a specific segment

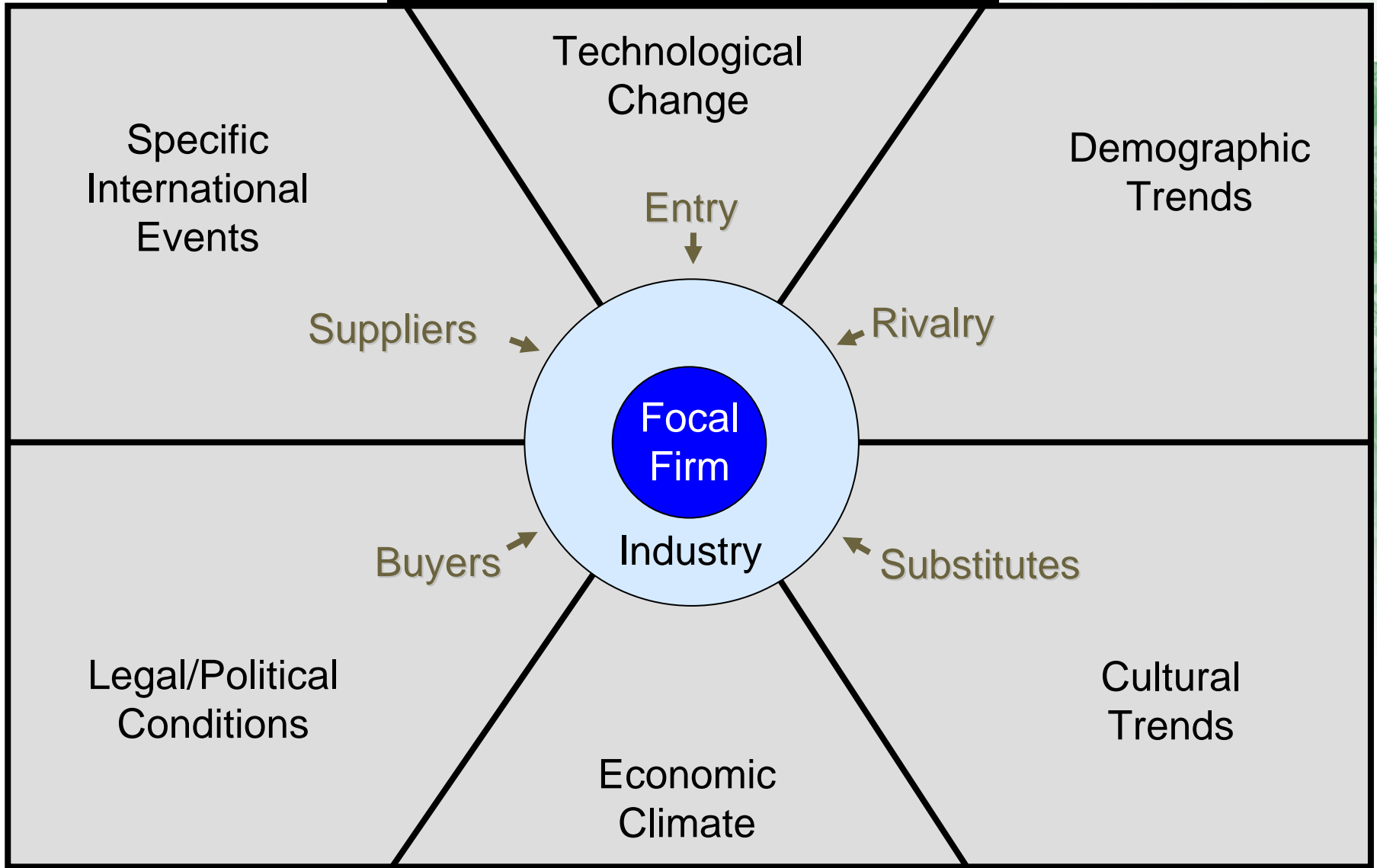
Industry Development over Time



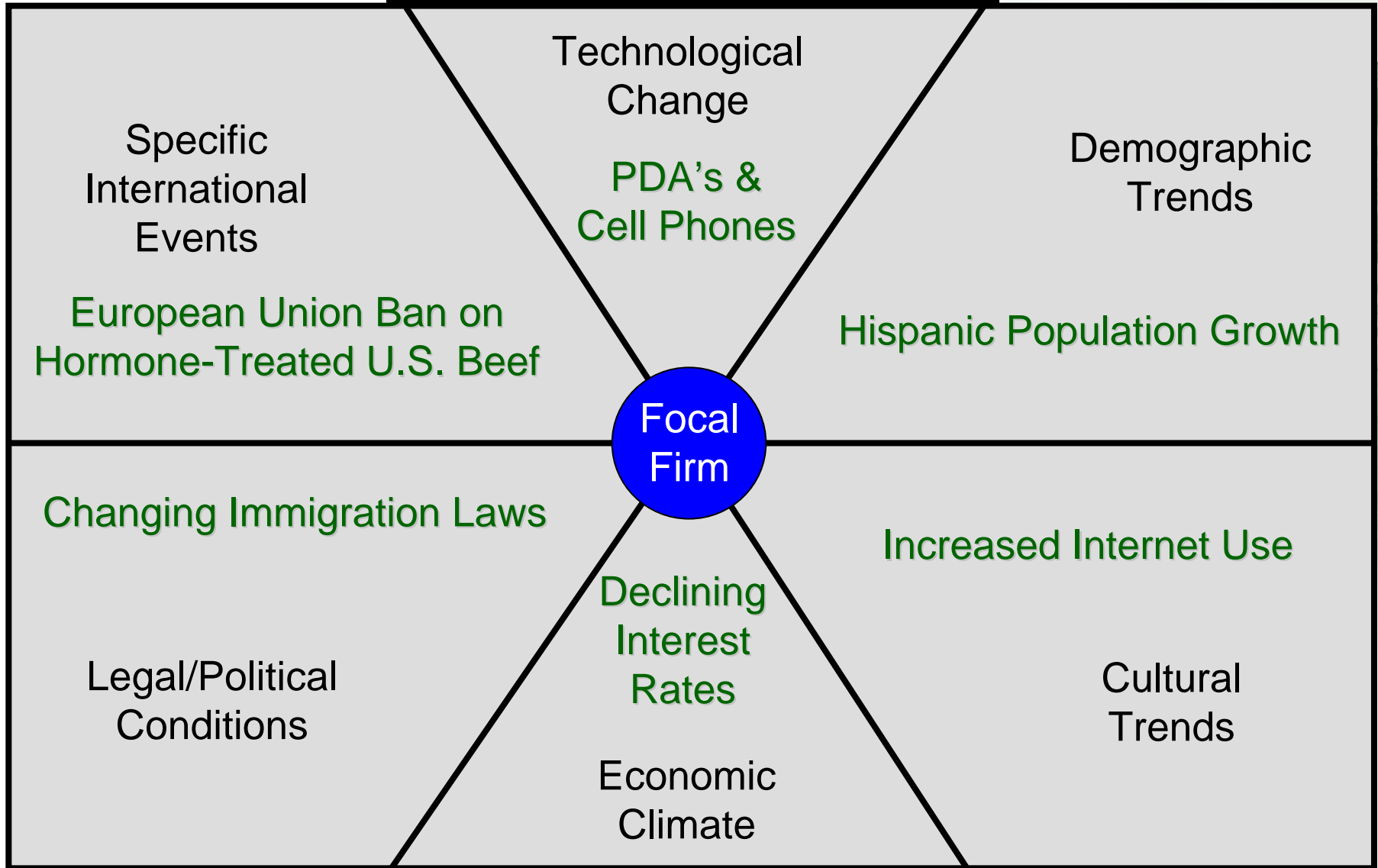
What Determines Firm Profitability?

- Macroeconomic factors
 - The overall state of the economy, regulation, interest rates
- Industry factors
 - Business environment and competitive conditions specific to an industry
- The firm's market position
 - The degree to which a firm is strategically benefited by the position it holds within an industry

General External Environment

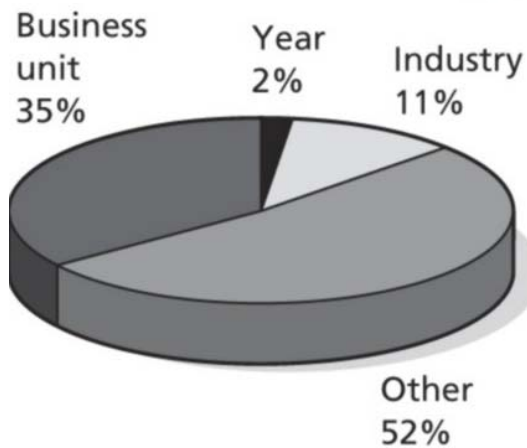


General External Environment

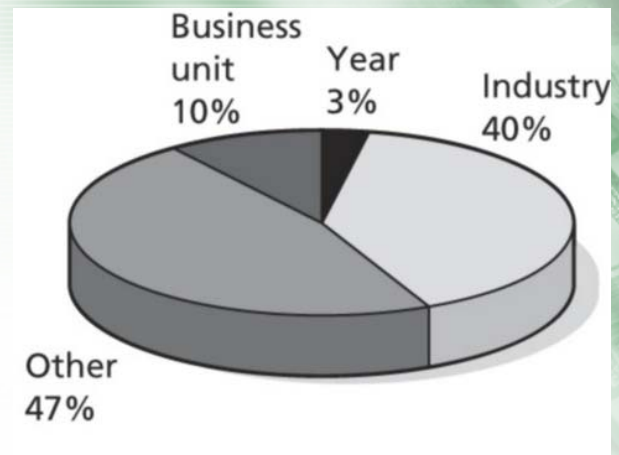


Relative Contributions of Industry and Business Unit to Economic Performance

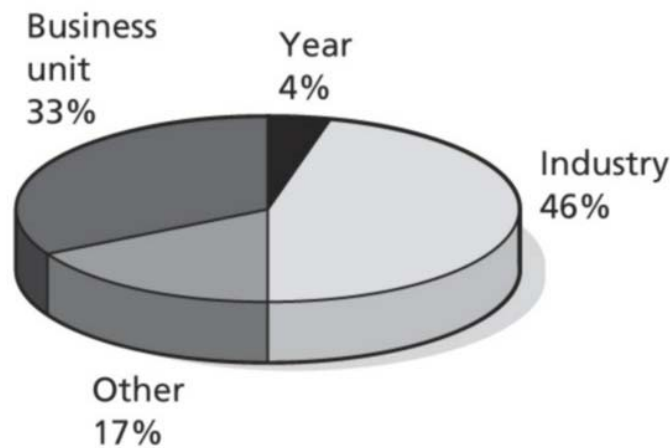
Manufacturing Sector



Transportation Sector



Services Sector



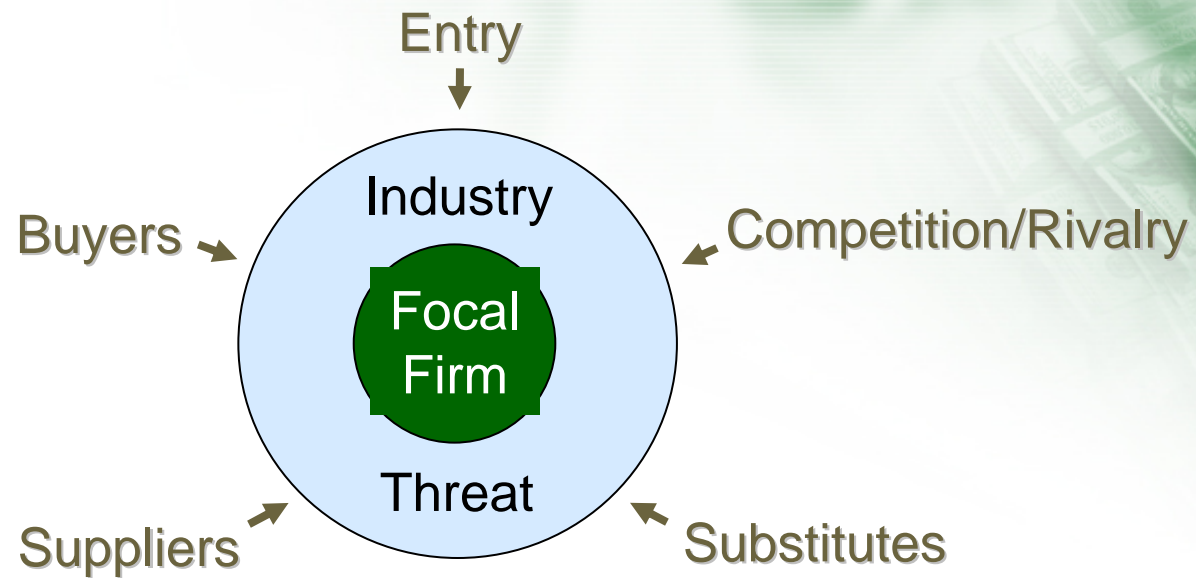
Percentage Contribution of Business Segment, Industry and Other Factors to Business Return on Assets 1980–1994 (U.S. data).

Forces Lowering Firm Performance

- Michael Porter lists five industry forces:
 - Strength of competition
 - Potential for entry into the industry
 - The power of buyers
 - The power of suppliers
 - The strength of substitutes for the industry's products
- When forces are strong profitability is low and when forces are weak profitability is high

Industry Analysis

Porter's Five Forces Model



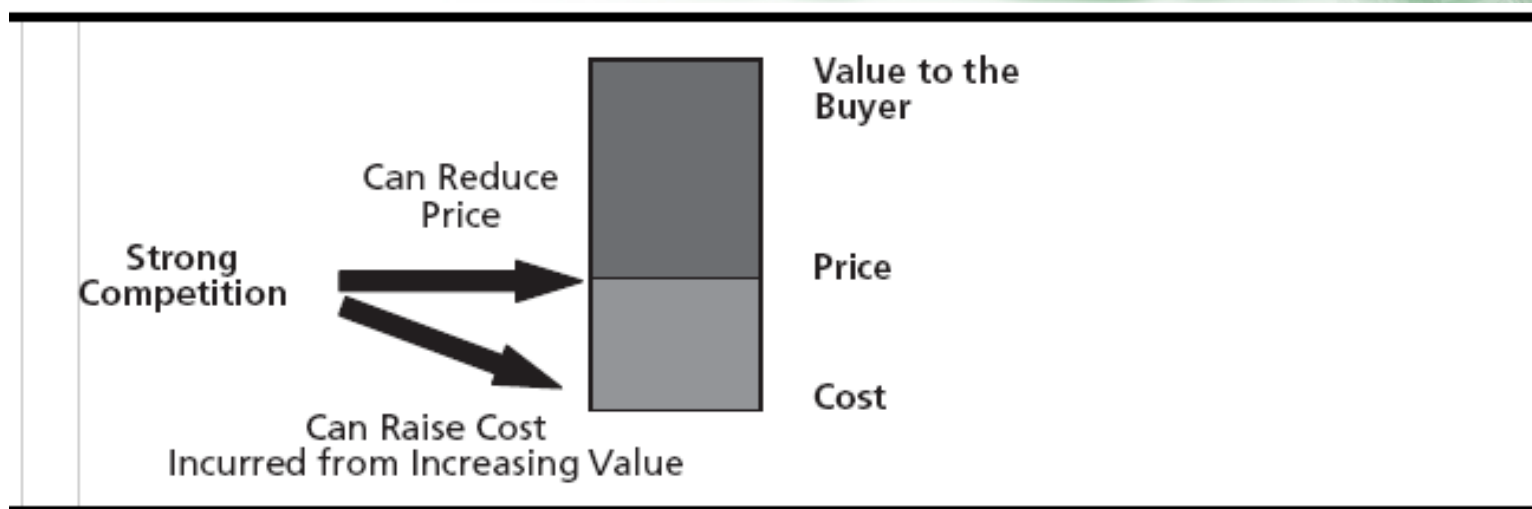
Higher Threat → Lower Average Profits

Porter's Five Forces Model

Competition

- May reduce prices so that customers don't need to pay full value for products
- May increase value without increasing prices

Effect of Competition on Transaction with Customers



Rivalry's Effects on Competition

- **Monopoly**
 - Absence of rivalry or competition
 - Firm's profits depend on customers and suppliers (keeping in mind substitutes available)
- **Perfect competition**
 - No firm makes a profit above its capital cost, since rivalry has driven the market price down to marginal cost.
- **Oligopolistic competition**
 - Localized competition occurs among a few similar firms within and across market segments.

Characteristics of Perfect Competition

- Characteristics of rivalry that lead to low economic performance:
 - Many competitors
 - A common set of buyers for all firms
 - The same value offered by all firms
 - The same cost structure in all firms
 - Relatively costless entry
 - Relatively costless exit
- ... A state of Perfect Competition

Characteristics of Oligopoly

- Industries Concentration is relative to:
 - Concentration ratios
 - Ratio of market size to the minimum setup costs necessary to compete
 - Level of sunk costs investment made by incumbent companies
 - Entrants are at a cost disadvantage to compete with the incumbents

Concentration-Profitability Relationship

- Causes of C-P Relationship
 - Higher efficiency among large firms
 - Non-cooperative strategic interaction to increase profits
 - Collusion to increase profits

Efficiency Differences among Firms

- Higher profits & growth are attainable by investing in cost-saving innovations
- Interaction with competitors and knowledge of their work not a necessary factor for profitability

Noncooperative Strategic Interaction

- Game theory: Firms act by observation and analyzing competitors' moves
 - Laying out how competitors will react valuable to potential profits
- Profits are possible in a noncooperative game
 - Duopoly
 - Price takers: quantity competition
 - Price makers: price competition

Collusion

- Tacit/ indirect collusion is relevant to firms with established strategies and profits above the competitive outcome
 - Required conditions
 - Mutual familiarity
 - Repeated interaction
 - Consistent roles
 - Strategic complementarity
 - Information signaling: A mechanism for coordinating decisions

Collusion (cont'd)

- Explicit/ direct collusion is the coordination of colluding firms' major decisions
 - It is hard to integrate and sustain
 - Extreme case of collusion leads to cartels
 - Firms function with the aim of increasing profits through non competitive behavior
 - Decide on cartel administration and policies
 - Have been made illegal
 - Present in firms that sell standard products

Forces Influencing Cartelization

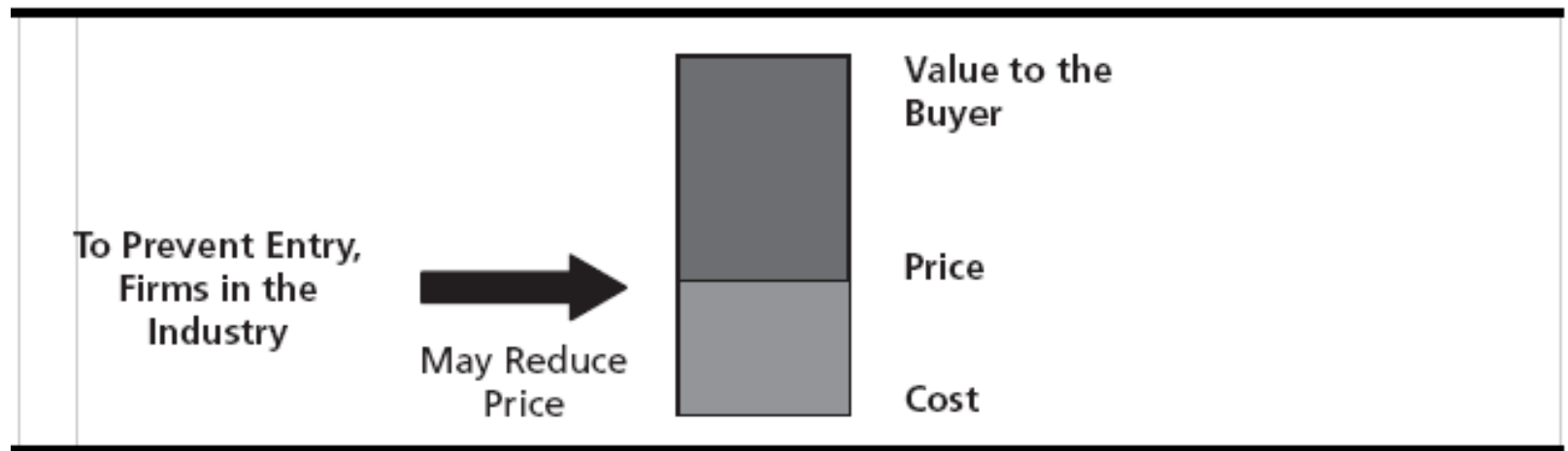
- **Reasons for establishment**
 - Homogenous market positions
 - Mutual familiarity through long-standing competition
 - Lack of viable substitutes and degree of industry concentration
- **Reasons for failure**
 - Inability to prevent entry into industries
 - Uncontrolled cheating or defection from cartels
 - Fluctuating demands
 - Bargaining problems within cartels

Porter's Five Forces Model

Factors Raising Barriers to Entry

- Lower prices by firms in the industry
 - Limit pricing
- High barriers to imitation
 - Property rights
 - Dedicated assets
 - Causal ambiguity
 - Learning curve and development costs
 - Economies of Scale
 - If you can't produce at min efficient scale, at a disadvantage
- High customer switching costs (Inc. Differentiation)
- Government Policies

Entry Barriers Affecting Transaction with Customers



Porter's Five Forces Model

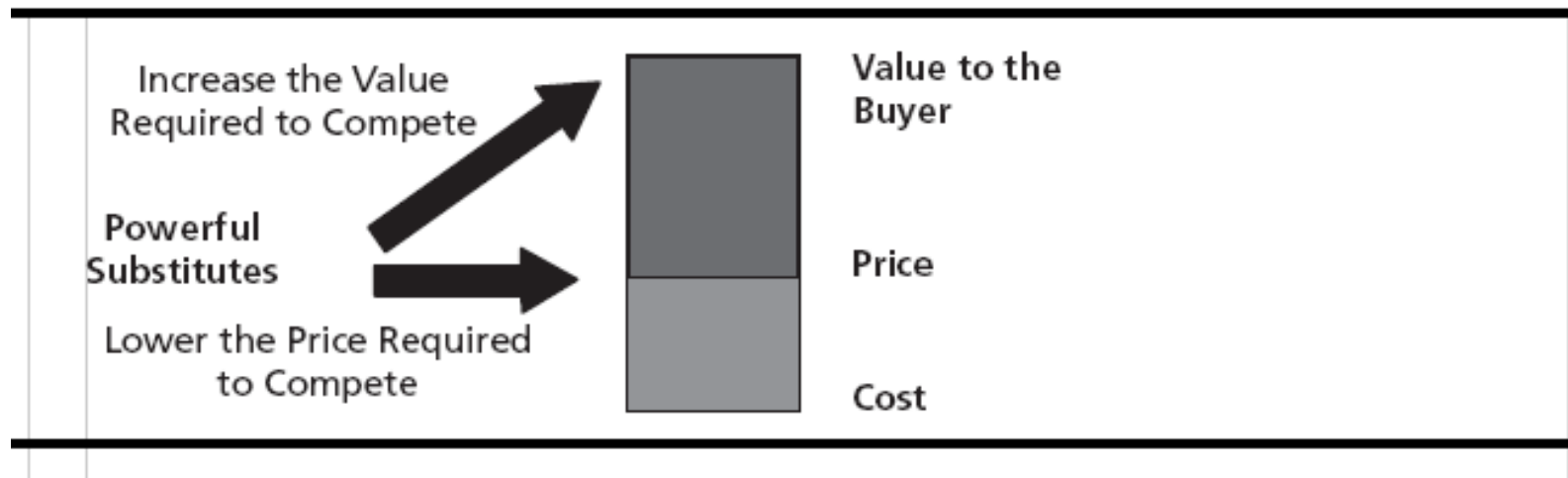
Threat of Substitutes

- Substitutes fill the same need but in a different way
 - Coke and Pepsi are rivals, milk is a substitute for both
- Substitutes create a *price ceiling* because consumers switch to the substitute if prices rise
- Substitutes will likely come from outside the industry—be sure to look

Substitutes

- The threat of substitutes increases when:
 - A firm has a low buyer surplus (value minus price) relative to the substitute.
 - A firm's customers have low switching costs.
- Defenses against substitutes:
 - Increase the buyer's surplus
 - Raise buyer's switching costs

The Effect of Substitutes on Transaction with Customers



Porter's Five Forces Model

Threat of Suppliers

- Powerful Suppliers can 'squeeze' (lower profits) the focal firm

Industry conditions that facilitate supplier power:

- Supplier concentration (few suppliers)
- Growth in supplied industry (buyer demand)
- Low percentage of supplier volume bought by customer (size of buyer relative to supplier)
- The strategic importance of supplier to buyer
- The strategic importance of buyer to supplier

The Effect of Supplier Power on Transaction with Customers

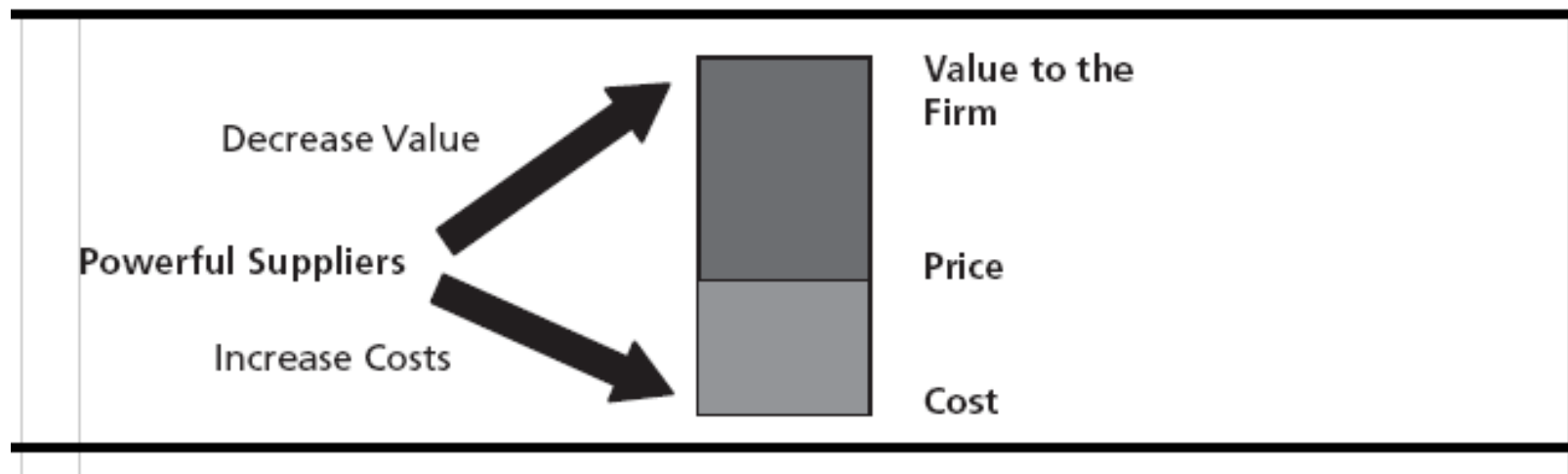


Figure 3.5

Porter's Five Forces Model

Threat of Buyers

- Powerful Buyers can 'squeeze' (lower profits) the focal firm by demanding lower prices and/or higher levels of quality and service

Industry conditions that facilitate buyer power:

- Availability of competing products with the same value and price
- Buyer concentration (few buyers)
- Low market growth
- Percentage of product sold to the buyer
- Low importance of the product to the buyer
- High importance of selling product to buyer
- Supplier need to fill capacity by selling to buyer
- Buyer's credible threat of vertical (backward) integration

The Effect of Buyer Power on Transaction with Customers

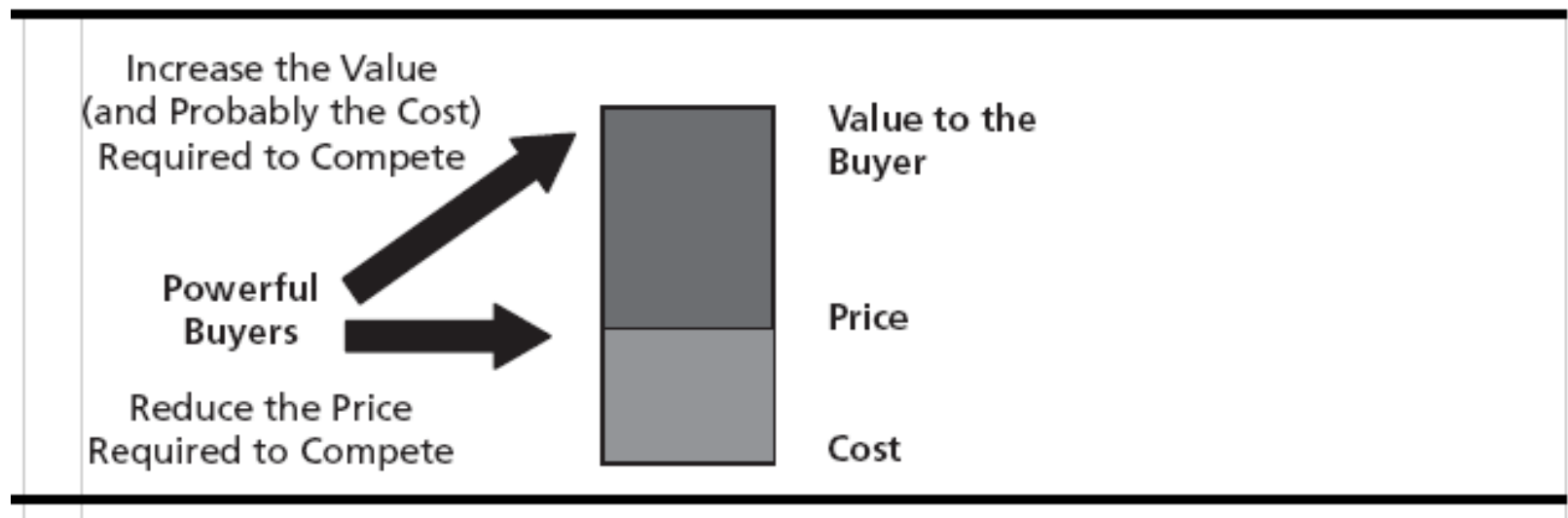
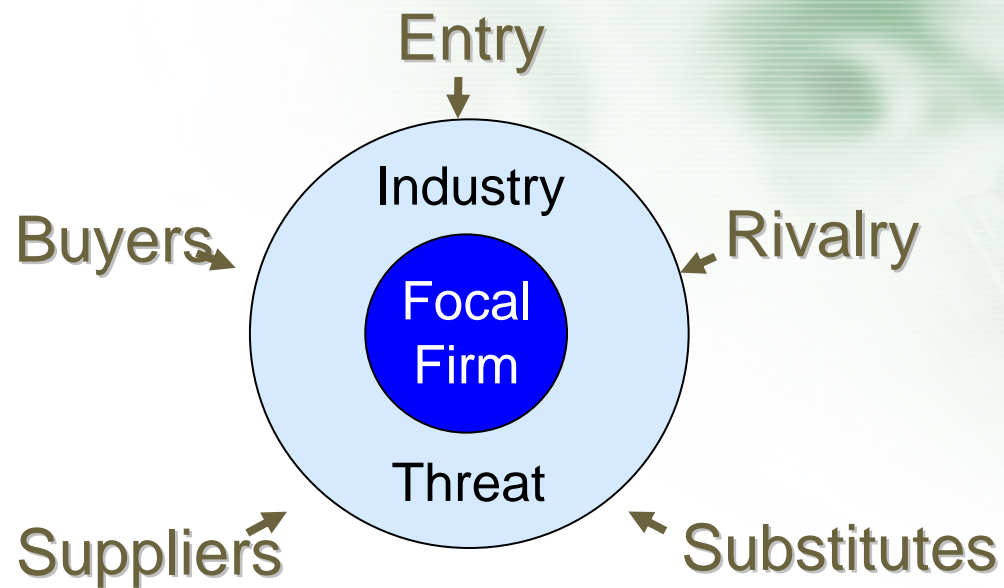


Figure 3.4

Porter's Five Forces Model of Competition



Next Time

- Apple Computer