

## **Chapter 2: Industry Analysis**

### **Introduction**

This chapter introduces students to external environmental analysis and a range of concepts, tools and frameworks including PEST analysis, Porter's five forces of competition analysis, segmentation analysis and key success factors. These tools and techniques are widely disseminated within the field of business and management so strategy instructors (whose modules often come towards the end of students' programmes of studies) may find that their students are already familiar with parts of this material and feel that they 'have heard all this before'. Unfortunately, more often than not, students' knowledge of external analysis proves to be somewhat superficial and these tools and techniques are applied in very mechanical, and not particularly insightful, ways. The challenge for the instructor is maintaining students' interest whilst, at the same time, conveying the importance of rigorous and detailed analysis. We find that the best way to do this is to focus on practice, not only through the liberal use of practical examples but also by encouraging students to think critically about the challenges of undertaking meaningful external analysis.

Our goals in this session are to ensure that students:

- are familiar with key frameworks used to analyse organisations' external environments and gain a sound understanding of how the structural characteristics of an industry influence competition and profitability;
- are able to use evidence on structural trends within industries to forecast likely changes in competition and industry attractiveness and to develop appropriate strategies for the future;
- are able to define the boundaries of the industry within which a firm is located;
- are able to recognize the limits of Porter's five forces of competition framework and extend the framework to include the role of complements as well as substitutes;
- are able to segment an industry into its constituent markets and appraise the relative attractiveness of different segments;
- are able to analyse competition and customer requirements in order to identify opportunities for competitive advantage within an industry (key success factors).

### **Lecture/ Instructor-led activity**

The number of sessions the instructor devotes to this topic area needs to be tailored to suit his or her class. If time permits two class sessions may be used to develop this topic – the first outlining the key frameworks (PEST, Porter's five forces model) and how these models are applied in a practical business context; the second exploring extensions to, and limitations of, the frameworks. When the delivery pattern is more intensive and face-to-face contact time is at a premium, instructors may prefer to ask students to read the first part of chapter 2 and to watch a short podcast outlining the key frameworks. The taught class then focuses on the value derived from utilizing these frameworks, the challenges that arise when applying these frameworks in practice and the academic critique of industry analysis.

A good starting point for a lecture is Table 2.1 on page 46 of chapter 2. The instructor poses the question, why does profitability vary so significantly between industries? Why, for example has the median return on equity between 2000 and 2010 been 27.8% for firms operating in the household and personal products industry but only 3.9% in the entertainment industry or in the case of the airline industry why have there been significant losses? The alternative is to take an industry where there are significant changes overall performance of firms over time. For example industries like mobile phones, personal computers or even horse racing where the margins have been squeezed and overall industry profitability has fallen over time. Presented with this question students often jump to conclusions or have produce glib answers but the instructor can emphasize the need for careful diagnosis and a deep understanding of the changes that have taken place in the external environment in relation to the underlying structural characteristics of industries. The introduction of short video clips or illustrative data at this point will help to bring examples to life.

The class proceeds by taking students through standard frameworks such as PEST and Porter's 5 forces. We find it useful to outline frameworks in relation to a selected industry example. Chapter 2 takes the Colorado marijuana-growing industry as the illustrative case but plenty of other examples exist that are equally likely to capture the students imagination (or relate to the students selected field of study) for example the video games industry, the DVD rental business, food retailing or even dredging. Industry that are being transformed by technology are often appealing to students, for example, the music industry or book publishing and provide a fascinating site for study but because the value chains of these industries are unbundling and re-bundling students can find these kinds of examples confusing. From experience, we find it is better to start with a relatively straightforward example and build in complexity once the fundamentals have been mastered.

We highlight the way in which the analysis can be applied in terms of forecasting industry profitability, positioning the organization and influencing industry structure to the business' advantage. Students are then introduced to some of the challenges of applying these frameworks in practice as well as the academic debate surrounding industry analysis.

### **Tutorial or student-led activity**

The emphasis is both chapter 2 and chapter 3 (resources and capabilities) is on the challenge of undertaking this kind of analysis in practice so tutorial activities designed around case material or group work investigating selected companies work best.

The closing case to chapter two centres Fitness First and the health club industry. Most students have some kind of appreciation of the fitness industry and allows will be able to draw on their own experiences as well as the case material when answering the case questions. The suggested answers also contain some tips on where students might find additional material. **Instructors who prefer to use longer cases are recommended to use the Auto Industry in 2012 case that is available on the web site together with a teaching note.**

## Teaching Note and Suggested Answers to the Fitness First and UK Health and Fitness Club Industry case

This case lends itself to a general class discussion that draws on students' own experiences of the health and fitness industry. A good starting point is to ask students to define the industry. The boundaries of this industry are fuzzy because the organizations operating in this broad field differ significantly in terms of the nature and scope of their activities and the sophistication, luxury and range of facilities they offer. At one end of the spectrum there are old style gyms with limited equipment and very basic showering and changing facilities, at the other end there are leading hotel chains and private health clubs that offer technologically advanced exercise equipment, swimming pools, saunas and steam rooms, fitness advice and luxurious relaxation facilities. For the purpose of this analysis we take the health club industry to include those businesses providing a full range of gym-based fitness facilities and providing fitness instruction. On the basis of this definition we exclude firms whose primary focus is on activities such as operating ice and roller-skating rinks, tennis centres or swimming pool complexes or the small start-ups that run boot camps in local parks. Of course we could define the industry more broadly as sports and recreation clubs or more narrowly as health clubs and spas. This case provides students with an immediate introduction to problems of defining industries and highlights the blurred nature of industry boundaries. Instructors could start the session by asking students to think about the boundaries of this industry and the key external factors affecting this industry before they progress to the question on industry analysis.

1. *How attractive is the UK health and fitness club industry in terms of its profit potential? Apply Porter's five forces of competition framework to the industry to justify your answer.*

The key aim of this question is to get students thinking critically about the ways in which underlying structural characteristics of industries shape competition. Emphasis should be placed on encouraging students to present and defend reasoned arguments and ask pertinent questions rather than coming up with 'the right answer' given that the data included in short cases are, by definition very limited.

### *The threat from substitutes*

From the customer's point of view there are numerous ways of improving ones fitness that don't involve health club membership –creating ones own fitness programme from advice in book or DVDs, joining a 'bootcamp' in a local park, becoming a member of a sports team and so on. We could argue that joining a health club is not just about fitness it is also about enjoying leisure and social activities in a pleasant environment and we might view health clubs as part of the much broader leisure and recreation industry but whatever way we define the industry numerous substitutes exist. Different consumers will, of course, have different preferences and loyalties that will colour their views how close a substitute other activities are for health club membership but, overall, we would suggest that the threat of substitution is high in this industry.

### *Rivalry*

The case refers to 'Intense competition within the UK health club sector' (p.73)and while the Fitness First CFO, John Wartig, notes that there has been some

consolidation in the industry (p.75) the prospects for the industry remain precarious. Students should be encouraged to dig a bit deeper into the five forces of competition framework. Porter suggests that rivalry depends on:

- Concentration
- Diversity of competitors
- Product differentiation
- Excess capacity and exit barriers
- Cost conditions

The case alludes to many of these factors. For example concentration appears to be relatively low given the large number of firms (public and private) in the market and the data in Tables 2.3 and 2.4 can be used to calculate a rough and ready 10-firm concentration ratio (based on number of clubs rather than market share). The case suggests that competitors are very diverse (for-profit and not-for-profit; small and large; specialist and non-specialist) and that excess capacity is emerging. Mention is made of the fact that 'the costs of operating a health club are much the same regardless of usage' (page 74) which invites students to speculate on the cost structures of established players in terms of the ratio of their fixed to variable costs. Low concentration, high diversity and a tendency towards excess capacity are likely to depress industry profitability but, the offerings of existing players are differentiated. The case also refers to increased growth in health club membership and consolidation taking place so there are forces at work that are both diminishing and increasing rivalry between existing firms. Overall rivalry would appear to be moderate to high. Students should be encouraged to consider the extent to which firms compete on price and to think about the complexity of pricing strategies in this industry.

#### *Threat of Entry*

Porter's framework highlights barriers to entry from capital requirements; economies of scale; absolute cost advantages; product differentiation; access to distribution channels; government and legal barriers. Not all of these barriers are applicable in this industry (e.g. access to distribution channels) but many are. General estimates of the costs of start-up are given at the bottom of page 74. It is also useful to draw attention to the barriers faced by new start-ups as opposed to those faced by cross entrants from other markets, for example, easyGym or the Hilton hotel groups. Overall the barriers to entry appear relatively low so the threat of entry is high.

#### *The Bargaining Power of Suppliers*

The case makes only a passing reference to suppliers of gym and fitness equipment on page 74. Students should be encouraged to think of other kinds of suppliers, for example, the suppliers of capital, labour or land (the sites which health clubs occupy). It seems reasonable to assume that the bargaining power of suppliers is moderate to low because in all these arenas there are a large number of suppliers in competition with each other.

#### *The Bargaining Power of Customers*

The buying power of customers (in this case health club members) depends on their price sensitivity and their relative bargaining power. The fact that many members pay their fees but then fail to make use of health club facilities suggests that consumers may not be as price sensitive as we might at first suppose. The instructor could suggest that students engage in some more detailed intra-industry analysis and speculate on the price sensitivity of different customer segments.

With regard to members' relative bargaining power, on the one hand it is relatively easy for consumers to switch health clubs or to choose to substitute an alternative kind of health and fitness regime for club membership. On the other hand an individual member has very little clout because he or she constitutes only a small part of the total membership. On balance the bargaining power of buyers in this industry is likely to be moderate to low.

In summary whilst in the past the industry has been attractive because changes in the external environment have produced rapid growth, many new entrants have been drawn in to the market and competition from substitutes, the threat of entry and rivalry between existing players has all led to the erosion of margins. Table 2.5 provides a number of measures of profitability. Rates of return on equity could be looked at in light of Table 2.1

2. *Should Fitness First cut back its investment in the UK and focus increasingly on expanding into Asia?*

Students can make use of Figure 2.5 'Identifying Key Success Factors' to structure their discussion. Before Fitness First expands its operations in Asia it needs to understand what its potential customers want and the nature and intensity of the competition it is likely to face. Asia is a very wide geographical market and there are likely to be wide regional variations which will require more finely grained analysis. The company also needs to consider its business model and capabilities can be leveraged in new settings, for example, Asian customers may be more price sensitive or less likely to pay subscription fees and not use the facilities than their UK counterparts.

3. *How could this industry be segmented? Is Fitness First right to move upmarket and offer an enhanced range of services to its members? Are there alternative strategies that Fitness First could pursue?*

There are numerous ways in which this market might be segmented. On the customer side we might segment on the basis of gender, age, income, socio-economic group, attitudes to fitness. On the supply side we might segment the market on the basis of the range of services offered (specialist e.g. body building versus full service e.g. gym, swimming, sports); the sophistication of the offering (basic through to prestige); the provision of health and fitness advice; location. The Sport England web-site provides some illustrative examples of dominant market segments by population at <http://segments.sportengland.org> which could be adapted to fit this context.

By combining different segmentation variables, a segmentation matrix can be constructed. For example:



	Budget	Mid-market	Specialist	Prestige
Professional male city dweller				
Female exercise class friends				
Young Mums				
Early Retirees				

Students should be encouraged to think about competition in different segments and the advantages or disadvantages of firms competing across multiple segments. In addition there may be some segments which are unoccupied, representing either an opportunity waiting to be exploited or an 'empty' segment for which there is little demand. By comparing organisations like McFit (low cost provider), Fitness First (mid-market) and Barceló (prestige) students will get a 'feel' for different market segments and different market positions.

Prior analysis should be used to express a view on whether Fitness First is right to move upmarket and offer an enhanced range of services to its members. For example, one might argue that there is significant excessive capacity in the up-market sector where major hotel chains are competing with dedicated providers so the upmarket segment may not be as attractive as it might first appear. In addition, given that margins are already slim, the cost of offering members additional services should not outweigh the revenue benefits. The discussion of alternative strategies might include consideration of ways in which Fitness First can make itself distinctive and enhance customer loyalty, for example, through use of digital technology, partnerships with providers of complementary goods and services, loyalty discounts etc

Students might also debate whether it is feasible for Fitness First to become a low-cost provider and to put forward a budget offering but this would not appear to fit well with its existing resources and capabilities.

4. *In what ways might Fitness First influence the course of the industry's evolution to its own advantage?*

Some strategies which firms might use to alter industry structure are implied in the case e.g. consolidation and the erection of higher barriers to entry (by increasing advertising and the knowledge and capital requirements needed to compete in the industry). If consumers respond positively to the provision high end facilities and the heavy use of technology then there is scope for Fitness First to use its size and 'deep pockets' to start to change the rules of the game. Lobbying for government intervention to raise the standards of staff training or the minimum requirements for licensing and insurance could have a similar effect. Students might also consider

how firms like Fitness First attempt to lock consumers in through their pricing and membership policies but should also note that changes in legislation may limit firms' abilities to enforce long-term contracts. Other ways in which Fitness First might influence the structure of the industry include consolidation through mergers or takeovers and the development of exclusive deals with large business organisations who subsidise employees health club membership.

**5. What do you think are the key success factors in this industry?**

Key success factors are outlined on pages 87-89. The templates used in Figure 2.5 and Table 2.2 can be reproduced for the UK Health club industry.

What do customers want?	How do firms survive the competition?	Key success factors
<p>Diversity of customer preferences but clubs need to be conveniently located – typically as close as possible to where customers live or work</p> <p>Customers willing to pay a premium for high quality facilities.</p> <p>Customers attracted by variety and novelty in fitness programmes and by proven results but increasingly seek 'value for money'</p>	<p>Low barriers to entry and exit, large number of substitutes.</p> <p>Costs do not vary significantly with increased usage of facilities, so maintaining optimal membership level is important</p> <p>Differentiation can lead to significant price premiums.</p> <p>Competition based on special deals and waivers rather than reductions in published membership fees</p>	<p>Locating clubs at popular sites and providing extended hours of access.</p> <p>Differentiation requires well qualified trainers, frequent updates to facilities and activity programmes and positive endorsements from existing members</p> <p>Building and maintaining membership requires sophisticated pricing with packages that are tailored to different customer groups.</p>

**Suggested Answers to Self Study Questions**

1. *From Table 2.1 select a high-profit and a low-profit industry. From what you know about the structure of your selected industry, use the five-forces framework to explain why profitability is high in one industry and low in the other.*

This is a straightforward question that requires students to use the framework outlined in Table 2.3 to analyse an industry of their choice. Common misunderstanding which need to be highlighted and corrected include:

- Poor /inconsistent definition of industry boundaries

- Confusion with regard to what constitutes substitution (as opposed to rivalry)
- Confusion with regard to the supply chain i.e. who are the suppliers, established rivals and buyers.
- Failure to distinguish different categories of buyers (e.g. retailer, end-users)

2. *The practical application of Porter's five forces framework reveals its many limitations. Discuss and suggest ways in which some of the limitations you identify might be overcome.*

The key elements of the answer to this question are outlined on pages 64-68 of chapter 2. The practical challenges include defining industry boundaries, deciding on the appropriate level of analysis, factoring in collaborators as well as competitors and dealing with environmental turbulence. In addition, the empirical basis for the model has also been questioned. Although it is often argued that Porter's five forces model assumes that industry environments are stable, predictable and bounded, there is a danger of overstating the case. The five forces framework can be used to take snapshots of an industry over time (comparative statics) and in many industries change occurs relatively slowly and in ways that the model can predict. However, there are exceptions. In high-tech industries, for example, change can be wholesale and very rapid and when the whole architecture of the industry changes the value of the five forces analysis is diminished.

In the second part of the question students are invited to discuss ways of countering some of the limitations of the model. The discussion could include a commentary on the significance of industry boundaries (to what extent does the precise delineation of industry boundaries matter anyway?); the use of intra-industry analytical frameworks (market segmentation analysis); the case for (and against) the inclusion of additional forces; the value of a 'comparative statics' approach (the extent of changes in industry structures).

More sophisticated answers might include some discussion of the limits of rational analytical approaches, characterised by frameworks of this type, and the ways in which such frameworks can shape as well as represent reality. From this perspective, the limitations of the model can only be overcome by recognising that there are no neutral ways of looking at the world and recognising that the framework represents a particular worldview.

3. *Aldi is a supermarket chain that has 8000 stores worldwide including the UK, mainland Europe, Scandinavia, the U.S and Australia. Although Aldi operates internationally most shoppers choose between retailers located within a few miles of each other. For the purposes of analysing profitability and competitive strategy should Aldi consider the discount retailing industry to be global, national or local?*

On pages 62 -63 we argue that there is no unique delineation of industry boundaries. The appropriate boundaries will depend on the task in hand. For store-level decisions (pricing, merchandising mix, opening new stores) Aldi will need to consider competition within its driving distance of its individual stores, where local



retailers are considered as substitutes from the customer’s point of view. For the purposes of forecasting company profitability and making most strategic decisions (e.g. setting capital expenditure budgets, introducing new store formats, restructuring logistics etc.) the discount retailing industry is best defined at a national level. Competitive forces tend to be relatively homogeneous within national boundaries – the identity of competitors, the strength of supplier power, entry conditions and so on do not vary greatly between localities. The case for defining discount retailing as a global industry is weak – national markets are distinct and there is little demand-side or supply-side substitution between them.

4. *How would you segment the restaurant market in your hometown? How would you advise someone thinking of starting a new restaurant what segments might be most attractive in terms of profit potential?*

To identify possible segmentation variables, begin with the basis on which consumer choose: e.g. cuisine, location, price level, quality, format (fast food, café, buffet, and waiter service restaurant). We can eliminate location by selecting just local markets. We can then combine the last four variables into a simple composite variable. This gives us just two segmentation variables that can be divided into the following categories:

		<b>RESTAURANT FORMAT</b>			
		<b>Fast Food</b>	<b>Café</b>	<b>Popular Restaurant</b>	<b>Up-Scale Restaurant</b>
<b>C U S I N E</b>	American (steaks, burgers, grills)	McDonald’s, Burger King	The American Dinner	Hamburger Heaven	Angus Steakhouse
	Fish	Pete’s Fish ‘n Chips	-	-	Loch Fyne
	Vegetarian	-	-	Manna, Gate	
	Italian	Pizza Hut	Marine Ices	Carluccio’s, Pizza Express	Artigiano
	French	-	Café Rouge	-	Bradley’s
	Indian	-	New Balti	New Dehli, Cumin Spice, Shahbag	-
	Chinese	Speedy Noodle	-	Mulan	ZeNW3
	Thai	-	Blue Moon	Bangkok, Bhan Thai	-
	Japanese	Wagamama	-	Benihara	Sushi Delight

In terms of identifying profitable segments, key criteria might include:

- Where is demand growth strongest (e.g. vegetarian cafes and popular restaurants)

- Where is competition weakest (avoid over-populated segments such as Indian, Chinese and Thai popular restaurants), explore segments that are empty or underserved (up-market Asian cuisine, Asian fast food?).
5. *What do you think are the key success factors in the:*
- *Pizza delivery industry*
  - *Formula One racing industry*

We look at key success factors on pages 68-70.

#### *The pizza delivery industry*

What drives customer choice?

The main considerations are price, information, proximity, food and service quality (including consistency and reliability). Hence the key success factors are likely to be:

- Location in a densely populated residential area with a high percentage of working people
- Strong local promotion (direct mail, local advertising)
- Effective production management: low costs through minimising waste, consistency in food preparation and cooking.
- Effective recruitment, control and scheduling of delivery personnel
- Brand equity

#### *The Formula One racing industry*

Posing the question “what does the customer want?” is more difficult in this context because the identity of the “customer” is less clear-cut. Are the customers the motor racing enthusiasts who watch the events, the media who purchase rights to broadcast events, sponsors and so. Success, however, comes with winning races and winning the constructors’ championships and to achieve this a Formula One team needs the best driver, the best car (engine technology, chassis design, aerodynamics), the best supporting team (pit stops, race strategy) and adequate financial resources. This suggests that key success factors include:

- The ability to recruit and retain talented drivers, technical and support staff
- The ability to attract and retain sponsorship
- Technological expertise and the capability to innovate (within the rules of Formula One racing)
- The development of strong working relationships between members of the team.