# Chapter 2

**Chapter 2**

# Analyzing the External Environment of the Firm

## Summary/Objectives

The purpose of this chapter is to familiarize students with techniques for evaluating a firm's external environment. This chapter focuses on the value managers add when they have a sense of events outside the company. By focusing on external events, managers are able to stay a step ahead of competitors by accurately anticipating and promptly responding to actions that can impact the organization. The chapter is organized into three sections.

1. The environmentally aware organization. Emphasize that managers use scanning, monitoring, and competitive intelligence to develop forecasts. Also, the role of scenario planning is discussed.

2. The influence of the six broad segments (demographic, sociocultural, political/legal, technological, economic, global) of the general environment of the firm.

3. The role of the competitive (also called the task or industry) environment and its analysis through the application of Porter's five forces model. We address how industry and competitive practices are being affected by the internet and digital technologies. We also address the concept of strategic groups. Managers use strategic groups to identify who its main competitors are and how a company fits in with the overall industry in which it competes.

## Lecture/Discussion Outline

This chapter's introductory case discusses how Citibank Hong Kong misread the market and eventually brought adverse effects to its reputation by promoting shark fin soup (with a restaurant chain, Maxim's). As Hong Kong is becoming a more environmentally aware Asian society, understanding the balance between what is perceived as a delicacy in the Chinese culture and the sensitivities of a generation that is growing up with greater environmental consciousness becomes key in managing in a foreign country.

(For additional information refer to: Wassener, B. 2010. A shark fin promotion backfires. www.green.blogs.nytims.com. July 22: np. )

? ***Discussion Question 1:*** *What are the key points in the case?*

***Discussion Question 2:*** *What other organizations have misread their external environment? What were the consequences?*

# I. Creating the Environmentally Aware Organization

We address three important processes—scanning, monitoring, and gathering competitive intelligence—which managers use to develop environmental forecasts. EXHIBIT 2.1 depicts relationships among these activities. Also, we address scenario analysis and its role in anticipating future major changes in the external environment as well as the role of SWOT analysis.

## A. The Role of Scanning, Monitoring, Competitive Intelligence, and Forecasting

### 1. Environmental Scanning

Environmental scanning involves surveillance of the firm's external environment to predict environmental changes to come and detect changes that are already underway. We discuss the example of how Procter & Gamble, with its wide range of household products, can be a good barometer of household spending.

***Discussion Question 3:*** *Why would a retail executive be at a disadvantage if s/he were not aware of such trends?*

EXHIBIT 2.2 provides some tips on how to spot important environmental trends.

***Discussion Question 4:*** *Would these "tips" be equally appropriate for all industries? Why? Why not?*

STRATEGY SPOTLIGHT 2.1 discusses how Zara, a Spanish fashion retailer, keeps abreast of trends and promising opportunities?

***Discussion Question 5:*** *Could such an approach be used in other industries? What investments would be required?*

### 2. Environmental Monitoring

Environmental monitoring tracks the evolution of trends, events, or streams of activities in the external environment. In this section, we present some of the factors monitored by three organizations: Motel 6, Pier 1 Imports, and Johnson and Johnson Medical Products. Such factors are vital for managers in determining their firm's strategic direction and resource allocations.

The SUPPLEMENT below represents the factors that the Director of Planning of Vought Aircraft considered critical. You may initially ask the students:

***Discussion Question 6:*** *What indicators do you believe a firm should monitor that produces both (1) weapon systems for the military, and, (2) key components for the commercial aircraft industry?*

**Extra Example:** Factors to Monitor—Vought Aircraft

Commercial Aircraft:

1. Oil prices
2. Age of fleet of airlines
3. Profitability of airlines

Defense Department:

1. Where weapons are in the life cycle
2. Mission requirements of the military

Source: Authors' interviews.

The SUPPLEMENT below discusses how Cisco, the $40 billion (2010 revenues) networking giant, learned from its mistakes during the Internet bust in 2001—and now carefully monitors its inventory levels. It points out that managers must monitor key aspects of the firm's internal environment—as well as the firm's external environment.

**Extra Example:** How Cisco Learned from Its Mistakes

In April, 2001, Cisco made one of the more painful confessions of the Internet bust: It had so much networking gear piled up that it had to take a $2.5 billion write-off for equipment that it figured nobody would ever buy. It has been working hard ever since to make sure that such a thing never happens again.

Supply chain chief Angel Mendez is grilled at monthly reviews by CEO John Chambers and other top executives. Now, Cisco has half the inventory it did in 2001—even though its revenues are twice as large. Says Mendez: "It didn't take John eight years to start asking questions (about inventory levels). He asks about every eight minutes."

Source: Burrows, P. 2009. Tech: Lean and Ready to Spring. *BusinessWeek*. April 27: 14-16.

***Discussion Question 7:*** *Are you aware of other firms that have failed to effectively monitor key aspects of their internal environment? (e.g., excessive numbers of employees and layers of management; high levels of inventory that became obsolescent; insufficient sales, marketing, engineers, etc. to meet increasing demand for goods/services and innovations, etc.?)*

### 3. Competitive Intelligence

Competitive intelligence helps firms define and understand their industry and identify rivals' strengths and weaknesses. Done properly, competitive intelligence helps a company to avoid surprises by effectively anticipating and responding to competitors' moves.

We briefly address the importance of competitive intelligence to firms in the banking, airline, and automobile industry.

**Discussion Question 8:** *What are other industries where competitive intelligence is extremely important? How might such information be collected?*

We address how the Internet has accelerated the speed at which firms can find competitive intelligence.

The following SUPPLEMENT provides an interesting perspective by Tracey Scott, past president of the Society of Competitive Intelligence Professionals:

**Extra Example:** The "People Side" of Competitive Intelligence

"I distinguish between secondary information—stuff that you read on the Web or in reports—and human-source information: stuff that real people tell you. Human-source information is more interesting and more accurate than secondary information. That's why I always look for 'star talent' and think about what the comings and goings of those people mean. I also love conference proceedings. Most companies send their best people to speak at conferences. It's a great way to track talent and to track down people who might have useful information and insights."

Source: Imperato, G. 1998. Competitive intelligence: Get smart. *Fast Company*. April-May: 270.

**Discussion Question 9:** *Do you agree with Ms. Scott's perspective? Do you feel she overstates her case? Why? Why not?*

STRATEGY SPOTLIGHT 2.2 discusses some of the ethical guidelines that United Technologies has implemented.

**Discussion Question 10:** *Are you aware of ethical guidelines that other companies have developed? Were they effective? Why? Why not?*

**Teaching Tip:** *The discussion of Competitor Intelligence provides the instructor with an opportunity to introduce the subject of ethics into the classroom. We suggest presenting scenarios that are not "black and white." For example, a firm advertises a position in order to get a chance to interview employees of a rival company with no intention to hire them. While this may not be illegal, clearly it is difficult to justify morally. The ensuing discussion will help to clarify the distinction between illegal and unethical behavior.*

### 4. Environmental Forecasting

Environmental scanning, monitoring, and competitive intelligence are important inputs for analyzing the external environment. However, they are of little use unless they provide raw material that is accurate enough to help managers make accurate forecasts.

We address the twin problems of either assuming that the world is certain and open to precise predictions, or the assumption that it is uncertain and totally unpredictable. And, we provide the famous example of poor forecasting by Digital Equipment Corp. which caused it to ignore the potential of personal computers.

? ***Discussion Question 11:*** *What are some other errors in forecasting with which you are familiar?*

### 5. Scenario Analysis

Scenario analysis provides a set of tools that enable managers to imagine threats and opportunities the future may bring. As a general rule, scenarios should be used by businesses whose external environments are prone to fundamental or sudden change and whose anticipation of such change is of vital strategic importance.

It is important to note that scenario analysis draws on a wide range of disciplines and interests, among them economics, psychology, sociology, and demographics.

? ***Discussion Question 12:*** *Why must scenario analysis and scenario planning draw on a variety of disciplines and interests?*

We provide the example of Lego, and how its position in the toy industry may become eroded if they define their industry—and its future—in a very narrow context.

STRATEGY SPOTLIGHT 2.3 includes the example of PPG Industries has benefited from the use of scenario analysis and planning.

## B. SWOT Analysis

We briefly address SWOT Analysis at this point. SWOT stands for strengths, weaknesses, opportunities, and threats. SWOT analysis provides a framework for analyzing these four elements of a company's internal and external environment.

It is important to note that SWOT analysis provides the “raw material”, that is, a basic listing of conditions and factors inside and outside of a company.

? ***Discussion Question 13:*** *What do you consider to be some of the major advantages and disadvantages of SWOT analysis? (This issue is addressed in more detail in Chapter 3, but you should point out that a key disadvantage is that strengths may not necessarily convert to sources of competitive advantage that are sustainable in the marketplace.)*

## II. The General Environment

The general environment consists of factors that can have a dramatic effect on a firm’s strategy. Typically, a firm has little ability to predict trends and events in the general environment, and even less ability to control them.

We divide the general environment into six segments: demographic, sociocultural, political/legal, technological, economic, and global.

EXHIBIT 2.3 provides examples of key trends and events in each of the six segments of the general environment

? ***Discussion Question 14:*** *How will the factors in Exhibit 2.3 affect specific industries?*

***Discussion Question 15:*** *Which factors are more difficult to predict than others? (e.g., macroeconomic changes are typically more difficult to predict than demographic changes)*

***Discussion Question 16:*** *How are these factors interrelated?*

***Discussion Question 17:*** *What factors do you feel are important that are not listed in this exhibit?*

### A. The Demographic Segment

Demographics are the most easily understood and quantifiable elements of the general environment. Demographics include elements such as the aging population, rising or declining affluence, changes in ethnic composition, geographic distribution of the population, and income level disparities.

? ***Discussion Question 18:*** *What are the implications of ethnic diversity for the work place?*

***Discussion Question 19:*** *What implications do the migration to the South and West in the United States have for individual businesses?*

***Discussion Question 20:*** *How does the "graying of America" affect U. S. companies?*

Among the trends we discuss are the aging of the population and how it may differentially affect a wide variety of industries. We also discuss the increasing number of wealthy Americans as well as changes in the geographic population of the United States.

The SUPPLEMENT below, addresses some interesting projections on the "aging" workforce and its implications:

**Extra Example:** The "Aging Workforce" and Its Implications

In the United States, the overall rate of the workforce growth will face a sharp drop. After peaking at nearly 30 percent in the 1970s (as the baby boomers as well as unprecedented numbers of women entered the workforce), and holding relatively steady at 12 percent during the 1990s and the present decade, the rate is projected to level off at 2 to 3 percent per decade thereafter. This translates into an annual growth rate of less than 1 percent today and a tiny 0.2 percent by 2020. The proportion of workers over 55 declined from 18 percent in the 1970s to under 11 percent in 2000. However, it is projected to rebound by 20 percent by 2015. Stated another way, we have recently passed what will prove to be a historic low in the concentration of older workers. Just when we have gotten accustomed to having relatively few older workers around, we have to start learning how to attract and retain far more of them.

During the next 15 years, 80 percent of native-born workforce growth in North America—and even more so in much of Western Europe—is going to be in the over-50 cohort. In the next decade or so, when baby boomers—the 76 million people born between 1946 and 1964, more than on-quarter of all Americans—begin their sixties and contemplate retirement, there won't be nearly enough young people entering the workforce to compensate for their exodus. The Bureau of Labor Statistics projects a shortfall of 10 million workers in the United States in 2010, and in countries where the birthrate is well below the population replacement level (particularly Western Europe), the shortage will hit sooner, be more severe, and remain chronic.

Source: Dychtwald, K. Erickson, T. & Morison, B. 2004. It's time to retire retirement. *Harvard Business Review*, 82 (3): 48-57.

**Ask:**

**?** ***Discussion Question 21:*** *It might be interesting to ask what the implications are for today's organization (e.g., how can firms attract and retain older workers, changes in financial and non-financial incentives, etc.) as well as for public policy (e.g., changes in tax policies, increasing the number of immigrants, etc.).*

STRATEGY SPOTLIGHT 2.4 discusses how China's rapidly growing middle class has increased demand for high-end consumer goods—and, consequently, revenues for air cargo carriers.

## B. The Sociocultural Segment

Sociocultural forces influence the values, beliefs, and lifestyles of a society. Examples include a higher percentage of women in the workforce, dual-income families, increases in the number of temporary workers, greater concern for healthy diets and physical fitness, greater interest in the environment, and families postponing having children.

**?** ***Discussion Question 22:*** *Name two industries that have benefited from the growing awareness about health and fitness. Also name two that have been adversely affected by this trend.*

***Discussion Question 23:*** *What must firms do to attract and retain women employees? Why are such efforts becoming increasingly important?*

The section also addresses the increased educational attainment of women in the workplace. We discuss increases in both the number of degrees granted to women as well as the increased formation of businesses by women.

**Ask:**

**?** ***Discussion Question 24:*** *Can you think of any other important implications this trend has for businesses in a specific industry?*

The SUPPLEMENT below addresses another sociocultural trend—the increasing number of prohibitions on cigarette smoking. It outlines the steps that some states are attempting to take to discourage smoking.

**Extra Example:** Controlling Cigarette Use by Raising Taxes

Cigarettes have been a political hot potato for years as one community after another in the U.S. has banned or restricted their use. Recently, legislators have taken another approach to curbing their appeal—raising prices. "If you raise the price by 10 percent, it should reduce overall consumption by about 4 percent and reduce youth smoking by 6 or 7 percent," according to Eric Lindblom, director for policy research at the Campaign for Tobacco-Free Kids.

But wait. It's usually companies that raise prices. How can legislators do that? By increasing taxes. Texas recently levied a $1.00 per pack excise tax and Maryland politicians are pushing for a dollar increase per pack in their state as well. California's Proposition 86, which would have increased cigarette taxes by $2.60 and boosted the price per pack to $6.55, was barely defeated. But supporters of that legislation have claimed they will try again in future elections. "Because of the link between tobacco and diseases such as cancer, California taxpayers are currently paying $86 billion annually in health care costs related to smoking. That means every family—whether or not smokers—is paying more than $860 a year. That's money that could pay for child care, doctor's bills or food," according to Maria Robles of the Coalition of Healthy California.

Sources: Asotra, K. 2007. Proposition 86 in California. Tobacco-Related Dsiease Research Program, www.trdrp.org, January. Byrnes, N. 2006. Big Tobacco's showdown in the West. *BusinessWeek*, September 11: 38.

**?** ***Discussion Question 25:*** *Are the legislative actions that politicians have taken to regulate and tax cigarettes improved the situation or made it worse?*

***Discussion Question 26:*** *What are some other examples of public health-related issues that politicians have attempted to control with legislation? How has the business community responded to or been affected by such legislation?*

The SUPPLEMENT below addresses a rather interesting issue: The tendency for Japanese workers to not take their annual vacation time. In fact, it has become such an urgent issue that the government is considering legislation to force people to take their time off.

**Extra Example:** Should Japanese Workers be Forced to Take Time Off?

Does Japan have workaholic employees? That might appear to be the case. And, they may be forced to take time off. In order to get citizens to dip into their estimated $7 trillion in savings and help revive the economy, the government is considering penalizing companies whose workers don't take their annual leave.

Similar to U.S. laws, proposed accounting reforms would treat vacations as pay and require businesses to hold cash reserves equal to their employees' stashed days. Some 92% of Japanese workers don't use up their vacation time—according to a recent glob al survey by travel site Expedia. On average, they use 7 of an allotted 15 days per year!

Prime Minister Taro Aso's administration says the vacation law could spur $121 billion in spending and generate 1.5 million jobs. However, critics say it may hurt struggling companies—and fail to loosen up outlays for leisure. Many Japanese "live to work," says Toshihiro Nagahama, senior economist at Dai-ichi Life Research Institute, "and wouldn't know how to enjoy more vacations."

Source: Hall, K. 2009. Take a break, or else. *BusinessWeek*. May 11: 14.

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***Discussion Question 27:*** *Should there be legislation such as the one proposed? Why? Why not? What other ways could the government stimulate consumer spending?*

## C. The Political/Legal Segment

Political processes and legislation influence the regulations with which industries must comply. Some important elements of the political/legal arena include tort reform, the Americans with Disabilities Act (ADA), the repeal of the Glass-Stegall Act in 1999 (now banks may offer brokerage services), deregulation of utilities and other industries, and increases in the federally mandated minimum wage.

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***Discussion Question 28:*** *What do you see as some of the pros/cons of the Americans with Disabilities (ADA) Act?*

***Discussion Question 29:*** *Do you think the federally mandated minimum wage should be increased? What are the implications?*

Another area where visa restrictions is having an important impact is "very close to home" — universities. In the SUPPLEMENT below we provide an example of one student who elected to attend an M.B.A. program in China (because of visa concerns in the United States) and the fact that applications from Asian students have declined by as much as 50 percent at some U.S. business schools.

**Extra Example:** Legislation on Visa Restrictions: Its Impact on U.S. Business Schools

Paul Foo was a very attractive M.B.A. applicant — he could have had his pick among America's most prestigious M.B.A. programs. A graduate of Cambridge University in England, he had worked for three years at an investment bank in his native Malaysia before applying to business school. The University of California at Berkeley offered him a half-tuition scholarship and Thunderbird in Arizona (American Graduate School of International Business) offered him a full scholarship. Although he felt the offers were tempting, he was concerned about immigration headaches.

Foo had heard horror stories about Asian M.B.A. students waiting up to six months for a visa to reenter the U. S. after summer break. He had also heard about difficulties finding jobs in the United States after graduation. Thus, Foo decided to attend the China Europe International Business School in Shanghai. (He even gave up a Fulbright Scholarship that was contingent upon his attending a university in the United States.)

Asian students are increasingly ignoring U. S. business schools, troubled by tougher U. S. immigration laws and enticed by China's rapid economic growth. Applications from Asian students are down by as much as 50 percent at U. S. business schools. This decrease is troubling since Asian students typically pay full tuition, says Richard E. Sorensen, chairman of the Association to Advance Collegiate Schools of Business.

Source: Ridgway, N. 2005. Brain drain. *Forbes*. September 5: 154.

We close this section with a discussion of how legislation in the U.S. has restricted the number of H-1B visas for highly skilled professionals. STRATEGY SPOTLIGHT 2.5 discusses the proactive step (e.g. setting up a research facility in Vancouver, Canada) to address this issue.

***Discussion Question 30:*** *Should the U.S. Congress increase the number of H-1B visas? Why? Why not?)*

The SUPPLEMENT below illustrates how Ryanair deliberately influencing public opinion to gain "free" publicity and influence legislation.

**Extra Example:** Ryanair: How to Influence the External Environment

When Ryanair decided to make the Hahn airport its Frankfurt destination despite it being more than 70 miles outside Frankfurt, its competitor Lufthansa decided to take them to court. Ahead of the court case in Cologne, Ryanair's CEO Michael O'Leary decided to run a promotion on the company web site sending out the message that those who came to the courthouse in Cologne with a banner insulting Lufthansa would receive a free ticket on one of Ryanair's flights from Hahn. Although only a handful of Germans showed up, the riot police was present, leading to considerble media coverage for Ryanair.

Source: Anderson, M., Froholdt, M. & Poulfelt, F. 2010. *Return on strategy: How to achieve it!* New York: Routledge.

? ***Discussion Question 31:*** *Are you aware of other examples of companies that are using external factors such as government regulations or negotiations?*

***Discussion Question 32:*** *Is it a good idea for firms to seek publicity by utilizing seemingly negative messages, such as Ryanair did towards Lufthansa?*

## D. The Technological Segment

Developments in technology lead to new products and services and improve how they're produced and delivered to the end user. Innovations can create entirely new industries and alter existing industries.

? ***Discussion Question 33:*** *Ask students to speculate on the impact of the following technologies on American industry: (1) the Internet, (2) manufacturing innovations (e.g., robotics), (3) genetic engineering/designer genes. (The last items may provoke some heated discussion regarding the ethical implications.)*

We discuss the key implications that the Internet, information technology, and nanotechnology has had on industry — in particular, its impact on productivity gains.

We also address a fascinating issue: some of the promising future applications of nanotechnology and how it will impact some industries.

We close out the section by addressing some of the "downsides" of technology. In addition to ethical issues, we discuss environmental damage, such as the emission of greenhouse gases. We discuss BP Amoco's innovative approach to this matter.

The SUPPLEMENT below points out some of the commercial spinoffs from national security R&D investments in the United States.

**Extra Example:** How National Security and Military R&D Has Civilian Uses

Although national security may be the salient goal of Sandia, Los Alamos, and other national laboratories, such military innovations are spawning several civilian applications. Consider:

**High Performance Computing**: National labs use supercomputers and advanced software to simulate nuclear explosions.

**Commercial Applications**: Goodyear, Proctor & Gamble, and others adapt the tools to design better tires, detergent bottles, and other household goods.

**Microsystems**: Sandia builds tiny electronic devices that can survive radioactive blasts.

**Commercial Applications**: Sandia opens its mircoelectronics labs to private companies developing biosensors and chips used in medical diagnostic gear.

**Nanomaterials**: Los Alamos develops ways to spin carbon nanotubes into fibers that strengthen weapons, aircraft, and armor.

**Commercial Applications**: CNT Technologies uses the method to create “super threads” for sporting goods and artificial limbs.

Source: Engardio, P. 2008. In technology. *BusinessWeek*. September 28: 63.

? ***Discussion Question 34:*** *Can you think of other ways in which government R&D has benefitted firms in the private sector? (e.g., advances in computer technology, robotics, etc.)*

The SUPPLEMENT below illustrates how technology improves the fuel efficiency of cargo ships and results in carbon reduction. It points out that technology is now one of the important key aspects of the firm’s external environment.

**Extra Example:** How Shipping Companies Use Technology to Improve Fuel Efficiency

The cargo ships that sail the world’s oceans are leading contributors to global warming. Commercial vessels emitted 3 percent of the world’s carbon in 2007, and that may increase to 18 percent by 2050, as global trade increases. U.N. measures to halve carbon emissions from shipping could come into effect as soon as 2012, so the industry is scrambling to clean up its act. “The marine industry is gearing up for the biggest revolution since World War II,” says Lee Sokje, an analyst at Mirae Asset Securities in Seoul. “You’re either ahead of the game or you’re out.”

Rivals, meanwhile, are exploring other routes to fuel efficiency. China Cosco Holdings is considering bringing back nuclear-powered cargo ships, introduced in the early 1960s. “We’re not only looking into nuclear but also wind energy and solar energy,” says Zhang Liang, president of China Cosco. Analysts warn that the costs of deploying some alternative energy technologies are prohibitive. “Ship prices are going to go through the roof if any of these ships using renewable energy are built,” says Mirae’s Lee Sokje.

Source: Park, K. 2010. Deconstructed: Big ships go green. *Bloomberg Businessweek.* May 17: 35.

? ***Discussion Question 35:*** *Are you aware of other cases where technology is a key factor that is reshaping an industry? What industries are most likely to be influenced by technological changes?*

***Discussion Question 36:*** *Do such initiatives tend to lead to advantages that are difficult to rivals to imitate? Why? Why not?*

## E. The Economic Segment

The economy has an impact on all industries, from suppliers of raw materials to manufacturers of finished goods and services, as well as all organizations in the service, wholesale, retail, government, and nonprofit sectors of economies. Key indicators include interest rates, unemployment rates, the consumer price index (CPI), the Gross Domestic Product (GDP), and net disposable income.

? ***Discussion Question 37:*** *Compare the impact of rising (or declining) interest rates on the overall demand for the following industries: (1) housing (will have a significant impact), (2) automobiles (will have a significant impact), (3) fast food (will have very little effect).*

EXHIBIT 2.4 discusses how the recent recession has affected the purchase of various types of alcoholic beverages, i.e., consumers have "traded down." Ask: What are some examples of firms that have done well in this recession? (e.g. Wal-Mart, other discount merchandisers.) Will such firms continue to do well as the economy improves in 2011 and 2012?

## F. The Global Segment

Globalization provides both opportunities to access larger potential markets and a broad base of factors of production such as raw materials, labor, skilled managers, and technical professionals. However, such endeavors carry many political, social, and economic risks. Examples of important elements in the global segment include currency exchange rates, increasing global trade, the economic emergence of India, China's admittance to the World Trade Organization, trade agreements among regional blocs (e.g., EC), and the GATT Agreement (lowering of tariffs).

? ***Discussion Question 38:*** *Provide examples of firms that have succeeded (stumbled) in their efforts to expand into international markets. What factors can explain their success (failure)?*

The SUPPLEMENT below suggests various implications of the earthquake that hit Japan in 2011to the global economy—given the extent of the globalization in the automobile industry.

**Extra Example:** The Global Implications of the 2011 Japanese Earthquake

A ferocious tsunami hit the coast of Northeast Japan on March 11, 2011 after a magnitude 9.0 earthquake. The tsunami slammed the coast and killed thousands of people as it swept away cars, hotels, and homes. Meanwhile, the Fukushima nuclear plant exploded and led to radiation leakage after the earthquake damaged the facility.

Damages also spread from the local to the global economy. Globalization may make Japan more vulnerable than in the past, as it offers Japan's export customers alternatives they might not have enjoyed a decade or two ago. Hyundai and Ford now are good substitutes for Toyota' cars, and even more so, Caterpillar tractors make in China can now replace Komatsu's earth movers.

Source: Morici, P. 2011. Japan crisis—The economic consequences of disaster. *www.foxnews.com*. March 15: np.

? ***Discussion Question 39:*** What are the risks associated with accessing a larger potential market overseas as a result of the process of globalization? Do the risks of globalization outweigh its benefits?

### G. Relationships among Elements of the General Environment

In our discussion of the general environment, we have addressed many relationships among the various elements.

EXHIBIT 2.5 provides many examples of how the impact of trends or events in the general environment can vary across industries.

STRATEGY SPOTLIGHT 2.6 addresses another important trend – the impact of the Internet and digital technologies on the business environment. EXHIBIT 2.6 illustrates Internet usage trends.

## III. <u>The Competitive Environment</u>

Here, we draw upon a well-known analytic tool, Michael Porter's five forces model of industry competition. We introduce this model and discuss examples of each force. We then address the impact of the Internet on the five forces and the strategic groups concept and its implications for studying rivalry and competition.

## A. Porter's Five Forces Model of Industry Competition

EXHIBIT 2.7 illustrates Porter's five forces model of industry competition

When introducing this model, it is useful to show how the model provides insight into an industry's dynamics and expected profit levels. The SUPPLEMENT below provides such an analysis on the paint and allied products industry. The analysis is restricted to the trade sales (i.e., house paint) segment of the industry. The competitive forces are very different for other segments such as the specialized high-tech automobile finishes.

*Note: For our purposes of illustrating the "basics" of the "five forces," the analysis has been simplified. We assume buyers to be consumers, although there are, of course, other distinct groups such as hardware stores, and large discounters such as Wal-Mart. Obviously firms' bargaining power vis-à-vis paint manufacturers vary significantly. Similarly, our analysis assumes the industry's products to be commodity products. However, there are exceptions, such as Olympic Stain, that have successfully differentiated their products on the basis of quality.*

**Extra Example:** The Paint and Allied Products (PAP) Industry

An analysis of the Paints and Allied Products industry (SIC 2851), using the five forces model, demonstrates why this industry has traditionally been caught in a price-cost squeeze and is unable to pass on rising raw material costs to its customers.

To illustrate the price-cost squeeze that this industry is facing, consider that between the years 1995 to 2000, the PPI (producer price index — the price for which it sells its output) of the PAP industry increased an average of only 2 percent. The PPI for petroleum refining and related products — a key supplier to this industry — increased at a rate of 6 percent over this same period of time. Hence the price of this key raw material was roughly twice the rate of inflation (about 3 percent); whereas, the PAP industry was lower than the rate of inflation. Thus, the PAP industry has been unable—due to unfavorable industry competitive forces — to pass on cost increases to their suppliers; thus eroding profitability.

Consider the PAP industry in terms of each of Porter's Five Forces:

Threats of Entry: Very High (minimal capital investment needed, little proprietary technology, regional firms can compete in local markets due to high transportation costs, little brand identification of existing competitors)

Buyer Power: Very High (low brand loyalty, relatively little product differentiation, relatively low switching costs)

Supplier Power: High (especially for petroleum derivative raw materials—a key input in industry)

Substitute Products: High (plastics, wood paneling, wallpaper coverings, etc.)

Rivalry: High (competition is based mostly on price competition, because of little brand loyalty and product differentiation; easy entry and exit from the industry gives rise to frequent price wars; little price leadership exhibited by larger firms)

Sources: www.bls.gov (Bureau of Labor Statistics); www.ita.doc.gov (International Trade Administration)

It is useful to point out that there can also be very profitable opportunities to compete in industries that have overall low profits, overall. For example, in the paint industry, Olympic Stain has typically been a very successful and highly-profitable firm because they have found an attractive niche in the market and developed a differentiated product (through product development and advertising).

### 1. Threat of New Entrants

After summarizing the major barriers to entry, ask students to provide examples of industries characterized by each of these entry barriers. This may help them to understand what initially may appear to be rather complex ideas.

We discuss the example of ProCD — a firm (producing electronic telephone books) that failed because of low entry barriers.

***Teaching Tip:*** *The chapter explains how economies of scale and economies of experience (learning curve) erect significant entry barriers. In the auto industry, U.S. manufacturers such as Ford and G.M. have high economies of scale (being the large producers) and all the benefits of learning curve (having been in the business for almost a century). Despite these advantages, foreign auto producers have entered the U.S. market and have increasingly gained market share over the past few decades. Ask the students why this happened? Does this prove that the concepts we discussed are wrong? Or does it point out that additional factors have to be considered? Point out that foreign producers have the benefits of lower labor costs and/or have developed better manufacturing technologies (such as Toyota's lean manufacturing).*

### 2. Bargaining Power of Buyers

Briefly summarize some of the conditions under which a supplier group may become powerful. It may be interesting how things have changed (if they have) with regard to the power of buyers of talent (i.e., businesses of varying sizes and industries) and suppliers of talent (i.e., business school graduates—either undergraduate or MBA).

STRATEGY SPOTLIGHT 2.7 discusses how universities (during the recent recession) may take advantage of their "bargaining position" when increasing tuition and fees that they charge students. Ask: Are such actions justified or not? (Caution: This may be a "high risk" question!)

### 3. Bargaining Power of Suppliers

Briefly discuss some of the conditions under which a supplier group may become powerful. The bargaining power of suppliers can be presented as the mirror opposite of the bargaining power of suppliers. For example, the relative sizes and concentrations largely determine the bargaining power of the two parties involved in the transaction.

The section discusses the relative power of the providers of talent — ranging from unskilled labor (low) to highly skilled professionals (high). Especially hard hit will be several unions such as those in declining industries such as steel manufacturing.

### 4. The Threat of Substitute Products and Services

Emphasize that the viability of a substitute product depends largely on its relative price-performance trade-off, i.e., more value for the same price or the same value for a lower price. Examples are electronic security systems versus security guards, and the use of steel versus plastic for components in the manufacture of automobiles.

We discuss substitutes and give the example of IBM's use of teleconferencing. Clearly, this technology poses a threat to the airline industry.

STRATEGY SPOTLIGHT 2.8 addresses the role of renewable resources as a substitute for fossil fuels.

The SUPPLEMENT below discusses a rather controversial substitute for conventional public and private universities – for-profit universities such as the University of Phoenix.

**Extra Example:** For-profit Universities — A Viable Substitute?

University of Phoenix executives stand behind the quality of Phoenix's education and business practices. They say they cater to underserved constituencies, such as adults who want to attend part-time and members of the military and minority groups. And, testing of their students shows improvement in reading and math, they say, and adult grads typically earn 9% to 27% more upon receiving degrees. "There's a lot of bias against recruiting into a college," says Terri C. Bishop, Phoenix's vice president for external affairs. "We recruit properly, and we take care of students once they're here."

However, critics point out that degrees earned at for-profit schools, including Phoenix, often carry less clout in the marketplace, despite price tags comparable to those at many public universities. "I don't think a degree from the University of Phoenix adds any value at all," asserts Edward Fleischman, chief executive of Execu/Search Group, a New York recruiting firm that specializes in financial services and health care. "It means you could not get into a better school."

Graduation rates at some for-profit schools tend to lag overall levels, at least by the federal standard. The Education Department measures the percentage of first-time undergraduates who obtain a degree within six years. Phoenix has a rate of 4%--among the nation's lowest, according to the government. The national average is 57.3%. However, Phoenix criticizes the federal approach as misleading since the school serves mostly older students who began college elsewhere. Phoenix claims a 38% overall graduation rate for students seeking bachelor's degrees.

Students also tend to incur far greater levels of debt after graduating from for-profit universities. According to data from the College Entrance Examination Board, the average total debt per for-profit university graduate is $29,900 versus $10,500 for graduates of public four-year schools. Phoenix contends that its graduates have debt levels of $14,200 to $25,221—depending on the degree sought. Tuition for a two-year associate's degree from Phoenix comes to about $19,500; a four-year degree costs about $51,600.

Source: LeVine, S. 2009. Scooping up college stimulus. *BusinessWeek*. March 23 & 30: 20-21.

? ***Discussion Question 40:*** *Do you feel that for-profit universities are a viable substitute for conventional public and private colleges and universities? Why? Why not?*

### 5. The Intensity among Competitors in an Industry

After discussing the factors that lead to intense rivalry in an industry, provide an example of an industry in which competition has recently been intense. For example, most students are familiar with the recurring price wars in the U. S. airline industry. Ask them to explain this using the factors discussed (e.g., undifferentiated service, low switching costs, slow industry growth, numerous competitors, etc.) You might point out that this industry was expected to report huge losses in 2001 even before the September 11, 2001 terrorist attack. Beginning in late 2005, the airlines' problems were further aggravated by extremely high fuel costs. And, the challenges continue, as fuel costs increase during 2011.

In this section we discuss the intense rivalry between Pfizer's Viagra (impotence treatment product) and a competing product developed by Eli Lilly & Company and Icos—Cialis. This provides an example that intense rivalry can take place on factors other than pricing in an industry that is highly profitable.

The SUPPLEMENT below is Michael Porter's response to a question as to whether or not he would add a "sixth force" if he were developing his framework today.

**Extra Example:** Should There Be a "Sixth Force?" Michael Porter's Perspective

"There have been two nominees for the sixth force. One is government. After much further work using and teaching the framework, I have reaffirmed my original conclusion that government is not a sixth force because there is no monotonic (direct linear) relationship between the strength and influence of government and profitability of an industry. You can't say that "government is low, industry profitability is high." It all depends on exactly what government does. Also, there are many different parts of government, each with its own distinct impacts. And, how do you assess the consequence of what government does? Well, you look at how it affects the five forces.

"The other, more recent, candidate for a sixth force involves organizations whose products and services are complementary to the primary organization's products and services. Again, there is no monotonic relationship between the extent of complements and profitability. Sometimes having many complements is consistent with high industry profitability, sometimes with low profitability. It has to do with how complements affect the five forces…Clearly, complements have much to do with the size of the pie, but their role in the division of the pie is independent on other factors."

Source: Argyres, N. & McGahan, A. M. 2002. An interview with Michael Porter. *Academy of Management Executive*. 16 (2): 43-52.

The SUPPLEMENT below points out how Borders is losing its battle for market share in a hotly contested segment of the retail industry. Defining and understanding a firm's industry and learning the strengths and weaknesses of rivals are key to surviving competition.

**Extra Example:** Borders Files for Bankruptcy: A Story about a Market Follower

Borders Group Inc., the second biggest U.S. bookstore chain, filed for bankruptcy in February 2011 after management changes, job cuts, and debt restructuring failed to make up for sagging book sales in the face of competition from firms such as Amazon and Wal-Mart. Borders immediately closed 200 of its 642 stores.

The world's largest online retailer, Amazon, is one of Border's strongest competitors. Borders launched online sales in 2008, more than a decade after Amazon.com revolutionized publishing utilizing e-commerce. Borders's president, Mike Edwards, commented: "Borders Group does not have the capital resources it needs to be a viable competitor." According to Michael Souers, an analyst for Standard & Poor's in New York, "They over-expanded and built up some debt on their balance sheet." He pinpoints a possible reason for Borders's sad story, "Instead of leading and being innovative, they were certainly a follower."

Source: Kary, T. & Sandler, L. 2011. Borders files bankruptcy, is closing up to 275 stores. www.businessweek.com. February 16: np.

? ***Discussion Question 41:*** *What are the advantages and disadvantages for market followers? Can a company gain in the long run by being a market follower?*

EXHIBIT 2.8 provides a summary of key points from the discussion of industry five forces analysis.

## B. How the Internet and Digital Technologies Are Affecting the Five Competitive Forces

The changes caused by the Internet economy have made strategizing more challenging. Strategic analysis, informed formulation, and successful implementation may be even more difficult in the Internet era because of the uncertainty surrounding the new technology. In this section we address the impact of the Internet and digital technologies in terms of Porter's five-forces model of competition.

The SUPPLEMENT below describes a digital business strategic perspective known as "Net- centric" that leading firms have adopted to guide their Internet strategies.

**Extra Example:** Net-Centric Companies: Giving Internet and Digital Technologies a Central Role in Strategy

It takes more than just having a website for a business to be an Internet company. Just ask Craig Barrett, CEO of Intel: "For us, an Internet company was always different from the prototypical dot-com . . . For Intel, being an Internet company meant turning ourselves into a 100 percent e-business from front to back — not just in terms of selling and buying, but also in terms of information transfer, education, and customer interaction." According to Barrett and the leaders of other successful digital businesses, the Internet is more than just a technology and more than just a channel. It's a mindset. After the recent boom and bust of the Internet economy, it is those companies that have made the Internet second nature that are here to stay. These companies have become "Net-centric" by succeeding in translating the possibilities of digital and Internet technology into everyday realities. Consider some of the characteristics that Net-centric companies such as Intel, Cisco, and Microsoft exhibit:

- Vital assets are within easy reach. Information is a vital asset. However, it's not about how much data a company has stored, but the distance between an employee and the information he or she needs at any given moment. For Net-centric companies, that distance is one click — it's all online and can easily be browsed.

- New ideas are aggressively cultivated. Net-centric companies know how to get ideas aired, vetted, and implemented with breakneck speed. There are no rules about whom an employee can pitch an idea to, no penalties for wasting a Vice President's time, and no stigma attached to backing a rejected idea.

- Customers help do the work. Any company can use the Internet to help its customers. But a Net-centric company turns its customers into an effective ad hoc R&D team. The Microsoft Office team has a system that, when a beta tester's computer crashes, allows the tester to instantly send a report via the Internet that outlines exactly what was happening at the time.

- Employees have "big" jobs. Net-centric companies spend a lot of time preaching to employees about goals — and relatively little time telling them how to achieve those goals. In these environments, expansive jobs that don't have a lot of role clarity free employees to make unique contributions and help build a sense of collective ownership in the companies broad strategic initiatives.

- Change is programmed into daily operations. Net-centric companies scan the digital horizon for trends, opportunities, and shortcuts to the future. And once they find a good idea, it doesn't take years for them to act on it. When these companies see something great, they have the technology — and the will — to act on it right away.

For Intel and other industry leaders, making the Internet second nature has been the key to lasting success. It has allowed them to achieve higher levels of productivity and efficiency that extend far beyond their Web sites. But according to Intel's Barrett, "what makes us an Internet company isn't the fact that we hit those numbers; it's the fact that we live and breathe this stuff now."

Sources: Dahle, C. 2001. Is the Internet second nature? *Fast Company*, July: 145-151; Osterhaug, A. 2005. Turning clicks into cash. *Fast Company*, October 15, www.fastcompany.com.

### 1. The Threat of New Entrants

In most industries, new entrants will be a bigger threat because the Internet lowers barriers to entry. Thus, scale economies may be less important in an Internet context and new entrants can go to market with lower capital costs.

Businesses launched on the Internet may enjoy savings on traditional expenses such as office rent, salaries, and postage. Thus, a new entrant could use the savings to charge lower prices and compete on price despite an incumbent competitor's scale advantages. Alternatively, a new entrant may be able to serve a market more effectively, with more personalized services and greater attention to product details. Then they could build a reputation in their niche and charge premium prices.

Another potential benefit for Internet-based businesses is access to distribution channels. Manufacturers or distributors that can reach potential outlets for their products via the Internet may be encouraged to enter markets that were previously closed to them. Such access is not guaranteed, however.

? ***Discussion Question 42:*** *What are some examples of industries where there have been a lot of new entrants because of the Internet? Have these new entrants been successful? How have incumbent firms reacted?*

**2. The Bargaining Power of Buyers**

The Internet may increase buyer power by providing consumers with more information to make buying decisions and lowering switching costs. But, by giving buyers new ways to access sellers, the Internet may also suppress the power of traditional buyer channels that have concentrated buying power in the hands of a few. In this section, we address two types of buyers: end users and buyer channel intermediaries.

End users are the final customers in a distribution channel. Internet sales activity that is labeled "B2C" is concerned with end users. Because a large amount of consumer information is available on the Internet, end users can easily shop for quality merchandise and bargain for price concessions. Switching costs are also potentially lower because the cost of switching may involve only a few clicks of the mouse to find and view a competing product or service online.

Buyer channel intermediaries are the wholesalers and distributors who serve as "middlemen" between manufacturers and end users. In some industries buyer channels are dominated by powerful players. The Internet, however, makes it easier and less expensive for businesses to reach customers directly. Thus, the Internet may increase the power of incumbent firms relative to these traditional buyer channels.

? ***Discussion Question 43:*** *What are some other ways that end users can increase their buying power by using the Internet?*

STRATEGY SPOTLIGHT 2.9 addresses the role of the Internet in empowering small independent publishers to access customers directly and avoid distributors which act as powerful intermediaries between the publishers and bookstores.

? ***Discussion Question 44:*** *What are some examples of other companies that have used the Internet to enhance their buying power?*

### 3. The Bargaining Power of Suppliers

The Internet has streamlined and quickened the process of acquiring supplies. But the extent to which the Internet is a benefit or a detriment to suppliers may depend on where the supplier is positioned along the supply chain.

Suppliers provide products or services to other businesses. The term "B2B" is used to refer to businesses that supply or sell to other businesses. On the one hand, the Internet makes it possible for suppliers to access more customers at a relatively lower cost per customer. On the other hand, because buyers can comparatively shop more easily and negotiate prices faster, suppliers may not be able to hold on to them. This is especially damaging to supply chain intermediaries, such as product distributors, who may not be able to stop suppliers from directly accessing other potential business customers.

? ***Discussion Question 45:*** *What can supply chain intermediaries do to strengthen their position, that is, make it worthwhile for their customers in the supply chain to continue using their services?*

***Discussion Question 46:*** *What are some examples of companies that have abandoned their traditional method of reaching customers and are using the Internet to reach customers directly?*

One of the greatest threats to supplier power is that the Internet inhibits a supplier's ability to offer highly differentiated products or unique services. Other factors may, in contrast, contribute to stronger supplier power:

1. The growth of Web-based business in general may create more downstream outlets for suppliers to sell to.

2. Suppliers may be able to create Web-based purchasing arrangements that make purchasing easier and discourages their customers from switching.

3. 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.

4. Suppliers will have greater power to the extent that they can reach end users directly without intermediaries.

A process known as **disintermediation** is removing organizations or business process layers responsible for intermediary steps in the value chain in many industries. The Internet is also 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. Electronic delivery is an example.

***Discussion Question 47:*** *What types of problems could arise from eliminating traditional intermediaries? Are there services or capabilities that might be lost? What are they?*

***Discussion Question 48:*** *What are some examples of new companies that have emerged to offer new types of electronic intermediary functions?*

The SUPPLEMENT below addresses the importance that major companies such as Home Depot are placing on the role of the Internet in changing the relationships between supply chain partners.

**Extra Example:** Home Depot Takes an "Anti-Disintermediation" Stand with Its Suppliers

How does a company protect its strategic position in its value chain? It must "own" the primary relationship with the ultimate customer served by the value chain. In a bold "anti-disintermediation" move, Home Depot sent a letter to 1,000 suppliers including Black & Decker and General Electric, stating that it will hesitate to do business with suppliers that market their own products online. Home Depot said it would be happy to partner with them on selling over the Internet, but maintaining the primary relationship with the ultimate customer is clearly the company's foremost rule of engagement.

Value chains are business assets that must be invested in, carefully managed, and continually enhanced. Home Depot was quick to recognize that the challenge of continuous value-chain optimization goes beyond its walls to all of its trading partners. Companies can't go it alone, and the challenges are immense. Nor will companies gain any sustainable advantage if they use business-to-business exchanges and other Internet-based procurement mechanisms simply to put the price squeeze on suppliers. The entire value chain must be optimized with win-win relationships forged from end to end.

Source: Fingar, P., & Aronica, R. 2001. Empower your customers -- The driving forces of the real new economy. *Internet World*, July 15: 33-35.

***Discussion Question 49:*** *If you were Home Depot, what would you do if one of your major suppliers responded that they intended to sell directly to consumers online anyway?*

**4. The Threat of Substitutes**

In general, the threat of substitutes is heightened because the Internet introduces new ways to accomplish the same tasks.

The primary factor that leads to substitution is economic — consumers will 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. Three examples are provided:

1. Online conferences by a company called Conferenza.
2. Online electronic storage by a company called MyDocsOnline, Inc.

***Discussion Question 50:** Do you feel that participating in a conference or a meeting online is an adequate substitute for actually attending? Why or why not? What are the advantages and disadvantages?*

***Discussion Question 51:** What are some other examples of Internet companies that are offering products or services that are viable substitutes for existing products or services?*

**5. The Intensity of Competitive Rivalry**

Because the Internet provides more tools and means for competing, rivalry among competitors is likely to be more intense. The Internet increases rivalry by making it difficult for firms to differentiate themselves and by shifting customers' attention to issues of price.

The SUPPLEMENT below addresses the way technology and a vast array of product choices has made brand loyalty a diminishing factor in marketing.

**Extra Example:** Regis McKenna on Brand Loyalty and the Internet

Regis McKenna came to Silicon Valley in the 1960s and put it on the map. He is the marketing genius behind the first Intel chip, the first Apple PC, and Genentech's first genetically engineered product. In his new book, *Total Access,* McKenna argues that the power of brands is rapidly diminishing.

"Brand loyalty is a vanishing reality. A root cause is technology. Technology has created a constant flow of new things into the marketplace, and lower- and lower-priced goods and services. Consumers have more choice than ever. Look at the grocery store. The average grocery store in America now has 50,000 different products on the shelves -- *50,000*."

"The Internet gives me access to an unlimited number of choices. For example, I'm looking for a digital camera with a certain set of features, and my son says to me, 'Well you ought to go on the Internet and just do a search for that and see what you come up with.' Brand isn't going to matter; what matter is what company comes out with the kind of technology and features I want at the price I want."

Source: Johns, A. 2002. The man who put the Valley on the map. *Business 2.0,* January: 100.

***Discussion Question 52:*** *What do you think the impact of diminishing brand loyalty will be on the intensity of competitive rivalry? Explain.*

***Discussion Question 53:*** *What are some examples of companies that still rely heavily on brand loyalty to maintain their market power and sales?*

Rivalry is more intense when switching costs are low and product or service differentiation is minimized. The Internet has "commoditized" products that might previously have been regarded as rare or unique. The Internet also eliminates the importance of location making products that were previously distant readily available online. This makes competitors more equally balanced, thus intensifying rivalry.

The problem is made worse for marketers because of shopping infomediaries that search the Web for the best prices. Such infomediary services may be good for consumers, but they increase business rivalry by consolidating the marketing messages that consumers use to make purchases to a few key pieces of information that the selling company has little control over.

***Discussion Question 54:*** *What steps can companies take to make their online business more distinctive or unique?*

***Discussion Question 55:*** *What are some examples of companies that have maintained the distinctiveness of their online business? What features make them distinct? Are these features sustainable?*

EXHIBIT 2.9 summarizes ways the Internet and digital technologies are affecting industry structure.

## C. Using Industry Analyses: A Few Caveats

This section was written as a "caveat" to address some limitations of Porters five forces model. First, managers should not always avoid low profit industries. We provide examples of Paychex and WellPoint Health Networks.

***Teaching Tip:*** *Even when industry analysis shows that an industry is unattractive, there are a few firms that seem to be able to earn high returns. For example, Southwest Airlines has been consistently profitable in an otherwise unattractive industry over the past several years. Does this mean that industry analysis is misleading? You may point out that industry analysis is useful to predict an industry's average profitability, but not necessarily, a single firm's profitability. This is a good opportunity to introduce the role of the strategist in outperforming industry norms.*

Second is the idea that business is not always a “zero-sum game”— which is an assumption that is implicit in Porter’s five forces model. We discuss how companies can collaborate with each other for mutually beneficial outcomes.

The SUPPLEMENT below provides a more detailed example of “win-win” relationships in the supermarket industry.

**Extra Example:** The Benefits of Close Supplier-Buyer Relationships

Experts in the supermarket industry believe that seamless partnerships between manufacturers and supermarkets would accelerate the deployment of sophisticated systems such as just-in-time delivery, electronic data interchange, and so-called efficient-consumer-response systems that permit manufacturers to monitor sales in stores and to produce and ship their goods in response to actual customer demand. Such cooperative systems could squeeze $30 billion in excess costs out of the industry by eliminating superfluous inventory, duplicate functions, and various middlemen. Moreover, the results witnessed when manufacturers and supermarket chains do cooperate suggest that both sides could increase sales volume by working together to customize offerings at different stores and for different end users. Cooperation between Kraft Foods and supermarket chains such as Publix Super Markets in Florida and Wegman’s Food Markets in upstate New York has generated significant returns for both sides.

Source: Kumar, N. 1996. The power of trust in manufacturer-retailer relationships. *Harvard Business Review*, 74(6): 95.

The third issue we raise is that the five forces analysis has often been criticized for being a static — rather than a dynamic analysis. Brandenberger and Nalebuff introduced the concept of the value net which we include in EXHIBIT 2.10.

The concept of complementors is often considered to be the single most important contribution of value net analysis. Complements typically are products or services that have a potential impact on the value of the firms’ own product and services. We provide the examples of complements (software and microprocessors) in the personal computer industry and the video game industry. (As we noted in an earlier supplement, Professor Michael Porter would not add complements to the “five forces” because they don’t have a *direct linear relationship* to industry profitability. However, they clearly can have an impact on an industry’s profitability.)

STRATEGY SPOTLIGHT 2.10 addresses the importance of complementors to the success of the Apple iPod.

The SUPPLEMENT below gives an update on the Apple iPod regarding the pricing of its iTunes downloads. Since many students, of course, are customers, they might have some strong opinions.

**Extra Example:** iTunes Changes Its Pricing Strategy

On April 7, Apple raised the price of its iTunes for many hit singles and selected classic tracks to $1.29. This breaks the psychological barrier of 99 cents in what could become the first big test of how much consumers are willing to pay to download individual songs.

The move, part of a new variable pricing strategy will also lower the price of selected songs, in an attempt by the music industry to wring more revenue from digital downloads in the battle to offset declining compact disc sales.

According to some, this is the sign of a maturing market. U.S. digital music sales topped $1 billion for the first time in 2008. However, it is estimated that average spending has leveled off at $41 per consumer. Asserts Russ Crupnick, a senior analyst for NPD Group: "If you're not drawing new people and your spending isn't growing, it's a natural part of the product life cycle" to raise prices, he said.

Source: Anonymous. 2009. iTunes raising prices April 7 on hit singles, classic tracks. *Dallas Morning News*. March 29: 3D.

**?** ***Discussion Question 56:*** *Do you agree with this move? Why? Why not? Will it impact your purchases of iTunes?*

## D. Strategic Groups within Industries

Most of your students are probably very interested in the automobile industry. EXHIBIT 2.11 provides a strategic grouping of the worldwide automobile industry. It is rather clear from the discussion in the text that the intensity of competition within strategic groups is much more intense than competition across groups.

The SUPPLEMENT below provides some more up-to-date information on Tata's exciting new Nano automobile.

**Extra Example:** More Information on the Nano

The Nano's formal launch was in late-March, 2009. But, unlike other brands of automobile—demand will far outstrip supply!

The first 100,000 Nano owners were randomly picked from bookings made from April 9 to 25, and their prices were protected. A 100,000 rupee ($1,980) dealer price was set.

A European variant will be launched in 2011, and Tata is also looking to the U.S., as the current economic situation has made low-cost cars even more attractive. According to Chairman Ratan Tata: "This was never conceived as the cheapest car, but as providing transport to those people who never owned a car. Driven mainly by the change in demand that we see elsewhere in the world, we suddenly felt we had a product that could be of considerable interest as a low-cost product in western Europe, eastern Europe, the UK and even the U.S."

Source: Krishnan, J. 2009. Update 2—Tata Nano to hit Indian roads in July. www.reuters.com. March 23: np.

? ***Discussion Question 57:*** *Do you think the Nano will be successful in other parts of the world—especially in developed economies? Why? Why not?*

Point out four benefits of strategic groups as an analytical tool:

1. Strategic groupings help a firm identify mobility barriers that protect a group from attacks by other groups.

2. It helps a firm to identify groups whose competitive position may be marginal or tenuous.

3. It helps chart the future directions of firms' strategies.

4. It helps in thinking through the implications of each industry trend for the strategic group as a whole.

It may be interesting to ask the students what dynamics they envision in the automobile industry, i.e., how membership in strategic groups may change and if new strategic groups may emerge.

? ***Discussion Question 58:*** *What are some of the strategic groups in other industries with which you may be familiar? What are the implications? (e.g., retailing)*

## ➢ IV. Reflecting on Career Implications

Below, we provide some suggestions on how you can lead the discussion on the career implications for the material in Chapter 2.

1. **Creating the Environmentally Aware Organization**: In your career, what are some ways in which you can engage in scanning, monitoring, and intelligence gathering for future job opportunities? Consider, for example, subscribing to your field's professional publications and becoming actually involved in relevant professional organizations.

This would be a good opportunity to suggest to the students the need for subscribing to business/professional publications and becoming actively involved in professional organizations such as the American Marketing Association.

2. **SWOT Analysis**: From a career standpoint, periodically evaluate your strengths and weaknesses as well as potential opportunities and threats to your career. In addition, strive to seek input from trusted peers and superiors.

We have found it always rewarding to ask the students to perform a personal SWOT analysis. Although at times it is a challenge to get students to engage in serious introspection, at the end of the class they would begin to appreciate both the relevance of SWOT analysis and the need to periodically take stock of their careers and personal lives in a systematic way.

3. **General Environment**: Carefully evaluate the elements of the general environment facing your firm. Identify factors (e.g., rapid technological change) that can provide promising career opportunities as well as possibilities for you to add value for your organization. In doing this, don't focus solely on "internal factors" of your organization.

Although in most classes students perform an analysis of the general environment of one or more industries, most of them have never made the connection between general environmental developments and their own careers. This question helps the students realize that just as products and services become obsolete, their skill sets can also become outdated. Similarly, changes in the general environment may present several new career opportunities to them.

4. **Five-forces analysis**: Consider the five-forces affecting the industry within which your organization competes. If the "forces" are unfavorable, the long-term profit potential of the industry may be unattractive. And, there will likely be fewer resources available and—all other things being equal—fewer career opportunities.

This is similar to the question 3 above. The goal here is to see that a five forces analysis can help them choose or change their careers, a connection that they seldom make.

## V. <u>Summary</u>

Managers must analyze the external environment to minimize or eliminate threats and exploit opportunities. This involves a continuous process of environmental scanning and monitoring as well as obtaining competitive intelligence on present and potential rivals. These activities provide valuable inputs for developing forecasts. In addition, many firms use scenario planning to anticipate and respond to volatile and disruptive environmental changes.

We identified two types of environment: the general environment and the competitive environment. The six segments of the general environment are demographic, sociocultural, political/legal, technological, economic, and global. Trends and events occurring in these segments, such as the aging of the population, higher percentages of women in the workplace, governmental legislation, and increasing (or decreasing) interest rates, can have a dramatic effect on your firm. A given trend may have a positive impact on some industries and a negative or neutral impact, or none at all on others.

The competitive environment consists of industry-related factors and has a more direct impact than the general environment. Porter's five forces model of industry analysis includes the threat of new entrants, buyer power, supplier power, threat of substitutes, and rivalry among competitors. The intensity of these factors determines, in large part, the average expected level of profitability in an industry. A sound awareness of such factors, both individually and in combination, is beneficial not only for deciding what industries to enter but also for assessing how a firm can improve its competitive position. We also address how industry and competitive practices are being affected by Internet technologies. We also addressed some of the limitations of Porter's five forces model, including its "zero-sum perspective" and its omission of the key role of complements. Although we discussed the general environment and competitive environment in separate sections, they are quite interdependent. A given environmental trend or event, such as changes in the ethnic composition of a population or a technological innovation, typically has a much greater impact on some industries than on others.

The concept of strategic groups is also very important to the external environment of a firm. No two organizations are completely different nor are they exactly the same. The question is how to group firms in an industry on the basis of similarities in their resources and strategies. The strategic groups concept is valuable for determining mobility barriers across groups, identifying groups with marginal competitive positions, charting the future directions of firm strategies, and assessing the implications of industry trends for the strategic group as a whole.

**Chapter 2: Analyzing the External Environment of the Firm**

***Explain the profitability of an industry (of your choice) by applying the tools that you learned in this chapter (five forces analysis). How can the five forces' "zero sum" perspective be a disadvantage?***

**Teaching Suggestions:**

*You can organize the discussion on this topic around the following sub-questions:*

*What are the five forces that drive the profitability in an industry?
The five forces are:
-The threat of new entrants
-The bargaining power of suppliers
-The bargaining power of buyers
-The threat of substitute products and services
-The intensity of rivalry among competitors in an industry

*What are the barriers to entry into a particular industry? Are they high or low?
What are the implications?

Six major sources of entry barriers as outlined in the text are:
-Product differentiation
-Capital requirements

-Switching costs (one time costs that the buyer faces when switching from one supplier's product or service to another)
-Access to distribution channels
-Cost disadvantages independent of scale
(These derive from: proprietary product, favorable access to raw materials, government subsidies and, favorable government policies)

*Who are the buyers in this industry? Are they powerful? What makes the buyers powerful (not powerful)? Are the buyers likely to engage in backward integration?

*What are the implications of buyers bargaining power?

*Who are the suppliers to your industry? Do you think the suppliers are powerful? What makes the suppliers powerful (not powerful) in your industry? Are there any 'switching costs?' What are the implications of high bargaining power of the suppliers in the industry?

*If you are a firm in this industry, how would you define competition? Would you consider all firms operating in the industry as your competitors? Why/why not?

*What are 'strategic groups?' How would you know the 'strategic groups' in your industry? What kind of dimensions should you choose when mapping the 'strategic groups?' Why is it important to understand 'strategic groups?'
*(We provide the example of the worldwide automobile industry on pages 70-71.)*

The concept of 'strategic groups' is important because competition would be more intense among firms within the same strategic group as compared to competition with other firms in the industry. Some dimensions that can be used for mapping strategic groups are: breadth of product and geographic scope, price/quality, degree of vertical integration etc.

You should emphasize that for strategic group mapping to serve any meaningful purpose, the dimensions should be chosen in a manner that they reflect the variety of strategic combinations in the industry. For example, in an industry where there is severe price-base competition, price may not be the right dimension to choose. Similarly, if all firms have the same level of product differentiation, then choosing product differentiation as a dimension would not serve the purpose.

*What are the substitutes to your products or services? How do substitutes impact the profitability of your industry?

You might want to make a point here that identifying substitutes can be quite a difficult task sometimes. Firms in seemingly unrelated industries may be providing products or services that act as substitutes to each other. The example given in the text on the substitution between airline industry and teleconferencing would help highlight this point.

Some more interesting questions to ask would be the following:

*If two industries have the same profitability levels, can you employ a common strategy in both the industries?

Even though two industries might have same profitability levels, the underlying industry structures can be entirely different. For example, in both the automobile industry and in the Internet-based businesses, profit margins are quite low. However, while the entry barriers into the automobile industry are very high, the barriers are very low into the Internet-based businesses. Competition is intense in both the industries whereas supplier and buyer bargaining powers are quite low. On the other hand, threat from substitutes such as the ‘brick-and-mortar’ stores, is very high in the Internet-based businesses whereas the threat from substitutes is low in the automobile industry (Some students might argue that airline industry is a strong substitute and you would have to deal with that objection). Thus, even if a firm operates in both these industries, it needs to formulate quite different strategies to suit the particular industry situation.

*Why is the five force analysis important?

It is important to understand these five forces because they affect a firm’s ability to compete in a given market. This analysis helps in deciding whether or not to remain in a particular industry and also in choosing industries to enter. A sound understanding of the forces operating in an industry helps in assessing how to improve the firm’s competitive position with regard to each of the five forces. You can ask students to give their own ideas on what strategies they would employ in the particular industries they have chosen for analysis.

*Is the five force analysis ‘zero sum’ in perspective?  Is that a disadvantage?

It would often be the case that students, in the position of a company, think about counteracting the effects of each force and blunting it. This is the essence of ‘zero-sum’ perspective. You can explain the importance of thinking ‘win-win’ and establishing collaborative partnerships with suppliers and customers. For example, 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 the market demands.

*****Do the competitive forces remain the same over a period of time? What impact will it have on profitability?

The key point is that in the five force analysis, we are essentially taking a point in time and trying to understand the industry situation at that point in time. This is a static approach to understanding the competitive environment. However, these external forces and the strategies of the firms within industries change over time and thus change the structure of the industry itself. In order to understand how the profitability changes over time, game theoretic approaches are being used.

*What is 'Value Net?' Who are on the vertical and horizontal dimensions? How are those on the vertical dimension different from those on the horizontal dimension? Who are 'complementors?' How are complements different from substitutes?
*(We provide the example of the video game industry on page 67-68.)*

The value net represents all players in the game and analyzes how their interactions affect a firm's ability to generate and appropriate value.

Suppliers and customers form the vertical dimension of the value net and the firm engages in transactions with them.

Substitutes and complements are on the horizontal dimension of the value net. These are the players with who the firm interacts but does not necessarily transact.

Substitute products or services serve the same purpose that the products and services from a chosen industry serve. Substitutes accentuate competition.

Complements are typically products or services that have a potential impact on the value of a firm's own products or services. The firms that produce complements are referred to as 'complementors.' For example, very sophisticated cameras may be useless if we do not have high quality film to produce quality pictures. Powerful hardware might prove useless without software to make it work and highly sophisticated software may be useless if there is no hardware to support its working. Thus complements in essence help to increase the performance and efficiency of products or services of a particular industry and thus improve their competitive situation vis-à-vis other products and substitutes.

# End-of-Chapter Teaching Notes

## Chapter 2: Analyzing the External Environment of the Firm

### Summary Review Questions

**1. Why must managers be aware of a firm's external environment?**

Response (pp. 40-41):

Being responsive to the external environment enables firms to avoid strategic mistakes. It is possible for firms to become internally focused, efficient producers of obsolete goods and services (e.g. buggy whips, carbon paper). Rather, managers need to respond to opportunities and threats from the external environment in order to develop the most successful products and services.

**2. What is gathering and analyzing competitive intelligence and why is it important for firms to engage in it?**

Response (pp. 41-44):

Competitive intelligence is a firm's activities of collecting and interpreting data on competitors, defining and understanding the industry, and identifying competitors' strengths and weaknesses. It is not spying, fortune-telling, simple data collection, or an isolated activity within a firm. The purpose of competitive intelligence is to increase management's awareness of developments in the external environment, thereby increasing the quality of strategic decisions.

**3. Discuss and describe the six elements of the external environment.**

Response (pp. 47-52):

The six elements of the general environment are the demographic segment, the sociocultural segment, the political/ legal segment, the technological segment, the economic segment, and the global segment. The demographic segment refers to the statistics of a population, such as age, income characteristics, ethnic groups, and geographic distribution. The sociocultural segment refers to the values, beliefs, and lifestyles of a country. The political/ legal segment refers to the creation and use of power within a country, including the effect of various regulations, including the areas of environmental protection, employment discrimination protection, and taxes.

The technological segment refers to new products and services derived from advances in engineering, applied science, and/or pure science. These new products and services can change manufacturing processes, create new industries, and alter the boundaries between industries. The economic segment refers to the level and change in monetary and macroeconomic factors such as unemployment, inflation, interest rates, and economic growth. The global segment refers to effects on a country's business environment from abroad, and include factors such as foreign competition, foreign market opportunities, foreign supply opportunities, legal changes due to international treaties, and regional economic integration.

**4. Select one of these elements and describe some changes relating to it in an industry that interests you.**

Response (pp. 52-55):

The answer will vary according to segment and industry chosen. Exhibit 2.5 may summarize some of the possible findings. The purpose of this question is to get students to classify various environmental changes into the segments and articulate why a change belongs in a particular segment. It might be useful to add a major change, the Internet, to the discussion. The Internet, from the technological segment, has wide-reaching impacts (see Strategy Spotlight 2.6, p. 54).

**5. Describe how the five forces can be used to determine the average expected profitability in an industry.**

Response (pp. 55-61):

The five forces model consists of the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, the threat of substitute products and services, and the intensity of rivalry among competitors in an industry. Each force can be looked at as a way that the industry environment limits a firm's ability to earn profits through either raising prices or lowering costs.

The threat of new entrants limits a firm's ability to raise prices because then a new entrant may decide to enter the industry an offer a lower price. The bargaining power of buyers directly limits a firm's ability to raise prices. The bargaining power of suppliers directly limits a firm's ability to lower costs. The threat of substitute products and services limits a firm's ability to raise prices because customers would then buy the substitutes. The intensity of rivalry among competitors in an industry limits a firm's ability to raise prices because then customers would buy from a competitor.

**6. What are some of the limitations (or caveats) in using five-forces analysis?**

Response (pp. 65-68):

Three limitations of the five-forces analysis are 1) the implication that low-profitability industries should be avoided may not be optimal. Low-profitability industries may be profitable opportunities for firms with innovative business models that change the competitive landscape. 2) The five forces model assumes a zero-sum game, with a firm's loss of profitability associated with another firm's gain. However, through strategic alliances or other forms of collaboration with suppliers, buyers, or other industry players, firms can gain both profitability and competitiveness. 3) The five forces model is static and does not account for constant changes in competitive position that characterize many industries. Included in the dynamic analyses is the effect of complements, or other products and services that affect the value of a firm's own products and services. For example, software is a complement to hardware. Dynamic interactions between firms and complements can affect the profitability prospects for a firm outside of the five forces model.

**7. Explain how the general environment and industry environment are highly related. How can such interrelationships affect the profitability of a firm or industry?**

Response (pp. 61-65):

The general environment can affect all of the five forces in various ways. A growing economy can reduce the intensity of rivalry within the industry because firms will be scrambling to meet growing demand. On pages, 61-65, there is a detailed explanation of how the Internet, a development in the technological segment, affects each of the five forces.

**8. Explain the concept of strategic groups. What are the performance implications?**

Response (pp. 68-71):

Strategic groups are groups of firms, usually within an industry, that share similar strategies. The performance implications are that firms can group themselves with close competitors and 1) identify barriers between groups, 2) identify positions within the industry that are marginal or tenuous, and 3) chart directions for future strategic development. Strategic group analysis is a more fine-grained way to conduct competitor analysis, as the competitive environment of an industry may differ from the competitive environment of the strategic group.

**Experiential Exercise**

**Select one of the following industries: personal computers, airlines, or automobiles. For this industry, evaluate the strength of each of Porter's five forces as well as complementors.**

Response:

This exercise is very useful for getting students to understand the value of the five forces model. For undergraduate and even graduate classes, it might be useful to work with only one force at a time. In general, for each of the five forces students may identify a number of firms and organizations. To evaluate the strength of each force, it is important to refer to relevant characteristics. The list below shows these:

- Threat of new entrants - you can look at the barriers to entry for the industry, as indicated by economies of scale, product differentiation, capital requirements, and switching costs. As well as other types of cost disadvantages to new entrants such as proprietary products, favorable access to raw materials, government subsidies, and favorable government policies.
- Bargaining power of buyers – identify buyers who are large or in concentrated buyer industries, standard or undifferentiated products, few buyer switching costs, buyer with low profits, buyer has a credible threat of backwards integration, or the buyer views the firm's products or services as undifferentiated.

- Bargaining power of suppliers – it is often a challenge to find suppliers, but to the extent you can, look for suppliers that are large and concentrated (few in number), suppliers with few substitutes, suppliers that view the firm's industry as a minor proportion of its sales, suppliers that provide an important input, suppliers with differentiated products, and suppliers pose a credible threat of forward integration.
- Threat of substitute products and services – identify substitutes that are a) outside the industry, and b) that are an economical and feasible alternative for buyers.
- Intensity of rivalry – identify rivals within the industry and evaluate each's product offerings for being lower priced or higher quality than the firm's offerings.

Then have students put them all together and provide a summary evaluation of the overall ability of the firm to set prices and control costs.

**Application Questions Exercises**

**1. Imagine yourself as the CEO of a large firm in an industry in which you are interested. Please (1) identify major trends in the general environment, (2) analyze their impact on the firm, and (3) identify major sources of information to monitor these trends. (Use Internet and library resources.)**

Response:

Students should respond with a variety of industries and approaches. It may be useful to have students justify their classification of trends into segments of the general environment. It may also be useful to have students justify why the trends they have identified are major trends and not minor trends. And you can ask students to classify their chosen trends as threats or opportunities. If students have focused on one, say opportunity, then ask them to consider threats.

As for sources of information, there are many good sources from the government. Try the census department, the Bureau of Economic Analysis, Department of Commerce, Department of Labor, and the Central Intelligence Agency. Many of these sources are freely available directly from the government or through libraries. Some libraries of institutions of higher education subscribe to industry analysts reports, which often include analyses of the business environment.. In addition, company websites often include information about potential market size and trends, although note that company websites are inherently a biased source of information.

**2. Analyze movements across the strategic groups in the U.S. retail industry. How do these movements within this industry change the nature of competition?**

Response:

We suggest following these five steps. First, develop a list of retailers. The list may be only include local retailers that the students are familiar with, or the stores within a local mall or shopping area, or even a comprehensive list of all retailers in the region.

Second, choose two dimensions for mapping the firms. Depending on the type of stores chosen, we suggest breadth of product line, degree of vertical integration, average store size, pricing strategy, or target market (broad versus niche).

Third, for each store assign a value for each dimension and plot it on the strategic group space. For example, Wal-Mart would have a broad product line, high vertical integration (it often buys directly from suppliers, not wholesalers), large size, low pricing, and broad target market. These assessments will determine its location on the two chosen dimentsions. In addition, for at least one firm get a sense of how it has changed in the past year or so.

Fourth, after putting your firms on the strategic group space, look for clusters and spaces between clusters. Evaluate each cluster. Ask students which clusters would be more profitable and which less so. And most important, ask why. Students should be able to articulate the desirability of each cluster, and link their reasoning to the dimensions used for mapping the firms. For the spaces, ask students if any of the spaces would be desirable places. Often, the groupings do not make sense. If that were the case, then challenge students to come up with dimensions that do make sense. You should help students to understand that they have control over how the strategic space is defined.

Fifth, for the firm that has changed in the past year, chart that movement on the strategic group space. No matter what dimensions you use, this firm will be moving away from some competitors and towards others. Ask students how this movement affects the competition between this firm and others. The purpose of the discussion is to get students to appreciate that increasing distance associates with less competition, and decreasing distance between firms represents a threat.

**3. What are the major trends in the general environment that have impacted the U.S. pharmaceutical industry?**

Response:

The U.S. pharmaceutical industry consists of firms that manufacture and market medicines for people. All segments impact this industry. The demographic segment affects demand, as the aging baby-boomers require age-specific medicines and marketing approaches. Also, older people tend to require more medicines than younger people, so market demand in the US is growing. The sociocultural segment affects medicinal preferences. People value their health and trust their doctors rather than use traditional medicines.

The political/ legal segment is extremely important due to the regulatory approval process for new medicines, intellectual property right protection, government insurance programs, and price controls. Regulatory approval of new medicines is extremely rigorous and costly. To recoup the costs of obtaining approval, pharmaceutical firms exploit their monopoly power that stems from the patents and trademarks on the medicines. And this monopoly power enables pharmaceutical companies to charge high prices. The recent trend in government support for prescription drugs through Medicare, and the recent and ongoing implementation of near-universal health care and prescription programs has two impacts: 1) more patients will be getting prescriptions, which increases revenues, and 2) more patients will be covered by insurance, which will increase buyer power and decrease revenue to pharmaceutical companies.

The technological segment affects the new product development process. Biotechnology involves the use of living organisms to develop new drugs, and has created an explosion in potential new medicines. Other technologies developed by these companies are the ability to test thousands of substances at a time and to map the human genome, which helps us to understand the causes and potential cures of many ailments.

The economic segment affects the industry, as general economic growth affects market potential. The recent recession has therefore hurt the industry. In addition, expected interest rates affect the financial prospects of many biotech firms. These firms often take decades to develop new drugs and bring them to the market. Lower interest rates enable them to make their investors' capital last longer. The global segment affects the industry in a number of ways. Foreign markets offer sales opportunities. Foreign labs are effective partners for collaboration. However, foreign countries often put price controls on medicines, which limit profit potential from foreign sales. And foreign competitors often do not respect the intellectual property of U.S. firms, giving rise to loss through piracy.

**4. Go to the Internet and look up www.kroger.com. What are some of the five forces driving industry competition that are affecting the profitability of this firm?**

Response:

A couple of clicks first to the "about the Kroger company" at the bottom of the home page, then to the Kroger Fact Books on the right side of the page will get you to the fact books. These include information on the following topics.

The first step is to define Kroger's industry. While Kroger does have Jewelry stores and houseware stores, its primary activity is in supermarkets. We will focus on supermarkets.

For the threat of new entrants, this force is weak. Krogers notes that the industry is consolidating. There are very large barriers to entry due to capital requirements and economies of scale.. The bargaining power of buyers is weak. The buyers are the general public, which is an aggregation of very small customers. No customer is a very large part of the market, and customers will not have an information advantage over Krogers. The primary source of buyer power is the ability of customers to shop at the competition. The bargaining power of suppliers is moderate. Some of Krogers stated competitive advantages stem from the brand equity of suppliers' products, such as Kitchen Aid, Levis, Dockers, and Nikon. However, Krogers counters supplier power by developing a series of corporate brands, and by backwards integrating into the suppliers' industries. The threat of substitute products and services is limited, as customers have developed a habit of doing most of their food shopping at supermarkets as opposed to farmers' markets, convenience stores, or general stores (although students may note the growing food offerings at retailers such as Wal-Mart or Target). And note that Krogers includes a number of other types of store formats, like marketplace stores and convenience stores, to compete in substitutes' industries. Alternatives do not have a very high market share. The intensity of rivalry among competitors in the industry is very strong. Krogers competes with Wal-Mart, Meijer, and other chains of supermarkets in every part of the country. These competitors are large, successful, and aggressive. Krogers limits rivalry by acquiring smaller stores and chains where possible. One of Krogers' strategies for dealing with rivalry is to encourage customer loyalty through various programs such as shopper cards and a customer relations management system in conjunction with London-based dunnhumby.

**Ethic Questions**

**1. What are some of the legal and ethical issues involved in collecting competitor intelligence in the following situations?**

**a. Hotel A sends an employee posing as a potential client to Hotel B to find out who Hotel B's major corporate customers are.**

Response:

The scheme risks exposure. Hotel B might find out who the employee is and find out that he or she represents Hotel A. Hotel B's list of major corporate customers is likely to be a trade secret, and Hotel A's use of fraud to gain the trade secret is, depending on state law and the specific circumstances, likely to be a crime.

It is likely that Hotel B will share this information with the press, trade publications, or other media. It is also possible that Hotel B will use this information to tarnish Hotel A's reputation. Hotel A's business could be affected and shareholders embarrassed. The cost to Hotel A of overcoming these shortcomings is likely to exceed whatever gain was possible.

b. A firm hires an MBA student to collect information directly from a competitor while claiming the information is for a course project.

Response:

It is possible that this action would be a crime, although doubtful. The competitor is not likely to share trade secrets, because the course project is not likely to be kept confidential, but that depends on the circumstances.

However, the scheme is certainly fraudulent and therefore unethical. The firm is using the MBA student as a spy, which is abusive to the MBA student. The student's college or university, though perhaps not directly involved, will have its name associated with the scheme.

In addition, the competitor can use the scheme to discredit the firm and embarrass its shareholders.

**c. A firm advertises a nonexistent position and interviews a rival's employees with the intention of obtaining competitor information.**

Response:

The scheme is fraudulent. Advertising a position without an intention of hiring is unethical. If the scheme succeeds in obtaining trade secrets, then it is probably a violation of law. And the coercive treatment of the rival's employees is a problem.

The possibility of criminal violations occurs within the purview of many states' trade secret laws. If any individual suffers any harm, then civil damages are possible.

But the unethical nature of this scheme is likely to be the largest problem. The rival can use the firm's actions to discredit the firm and embarrass its shareholders.

**2. What are some of the ethical implications that arise when a firm tries to exploit its power over a supplier?**

Response:

A monopsonist, or a firm that is the only buyer in a market, has great power over suppliers. It might try to exploit this power by forcing the supplier to reduce prices or provide extra services. In the extreme, suppliers will be forced to cut costs, lay off employees, cut salaries, and forego investments in new technologies or capabilities. The downside of these actions is that the supplier is less capable of contributing to industry development by infusing it with innovations.