

## CHAPTER 2

# External Analysis: The Identification of Opportunities and Threats

### SYNOPSIS OF CHAPTER

The purpose of this chapter is to familiarize students with the forces that shape competition in a company's external environment and to discuss techniques for identifying strategic opportunities and threats. The central theme is that if a company is to survive and prosper, its management must understand the implications environmental forces have for strategic opportunities and threats.

This chapter first defines industry, sector, market segments, and changes in industry boundaries. The next section offers a detailed look at the forces that shape competition in a company's industry environment, using Porter's Five Forces Model as an overall framework. In addition, a sixth force—complementors—is introduced and discussed.

The chapter continues, exploring the concepts of strategic groups and mobility barriers. The competitive changes that take place during the evolution of an industry are examined.

Next the chapter considers some of the limitations inherent in the five forces, strategic group, and industry life cycle models. These limitations do not render the models useless, but managers need to be aware of them as they employ these models.

Finally, the chapter provides a review of the significance that changes in the macroenvironment have for strategic opportunities and threats.

### TEACHING OBJECTIVES

1. Discuss the main technique used to analyze competition in an industry environment—the five forces model
2. Describe the concept of strategic groups and illustrate its implications for industry analysis
3. Discuss how industries evolve over time, with reference to the industry life cycle model
4. Show how trends in the macroenvironment can shape the nature of competition in an industry

### OPENING CASE

#### *THE UNITED STATES STEEL INDUSTRY*

The U.S. steel industry has been met with numerous problems for the last few decades. Factors contributing to its demise were falling trade barriers, competition, decreasing demand, excess capacity, and unionization. With bankruptcies and consolidation, restructured enterprises were now faced with productive workforces and new technology. With a decline in the value of the U.S. dollar after 2001, more steel exports were created resulting in competitive pricing and higher profits. With many countries spending for infrastructure rebuilding to stimulate their economies, demand for steel surged and allowed for price increases and profitability for U.S. steelmakers, even in the face of a U.S. recession.

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**Teaching Note:**

This case introduces many of the themes of Chapter 2, including the impact that competitive forces have on industry behavior and profitability, concepts about market segmentation and strategic groups, and the changing nature of competition over an industry's life cycle. One of the most important lessons of this chapter and this case, and one that may be somewhat surprising to students, is the very strong influence that external environments can have on firm performance. Much of what is discussed in the popular business literature focuses on the achievements or shortcomings of individual managers and other forces internal to the firm. But it is worthwhile to remind students that external forces can have just as much impact and can even cause the demise of industries with competent managers.

**LECTURE OUTLINE**

- I. Overview
  - A. For a company to succeed, its strategy must either fit the industry environment in which it operates, or the company must be able to reshape the industry environment in which it operates to its advantage through its choice of strategy. Companies typically fail when their strategy no longer fits the environment in which they operate.
  - B. To achieve a good fit, managers must understand the forces that shape competition in their external environment. This understanding enables them to identify strategic opportunities and threats. **Opportunities** arise when a company can take advantage of conditions in its environment to formulate and implement strategies that enable it to become more profitable. **Threats** arise when conditions in the external environment endanger the integrity and profitability of the company's business.
- II. Defining an Industry
  - A. An **industry** can be defined as a group of companies offering products or services that are close substitutes for each other. Close substitutes are products or services that satisfy the same basic consumer need. Firms within the same industry are rivals, also called **competitors**.
    1. A correct industry definition can be the difference between success and failure.
    2. Managers must define industries based on the customer need (the demand side of the market) and *not* the products the industry offers (the supply side of the market).
  - B. Several industries combine to create a **sector**. For example, the PC industry, the handheld industry, and the mainframe industry together create the computer sector.
 

*Figure 2.1: The Computer Sector: Industries and Segments*
  - C. Within industries, customers with a common need group together to form a **market segment**. For example, the soft drink industry contains regular, diet, and caffeine-free market segments.
  - D. Industry boundaries are not fixed, but can change over time. Industries may fragment into a set of smaller industries, such as when the auto industry fragmented into the car and SUV industries. Industries may also consolidate, such as the blurring of the boundary between the handheld computer and cell phone industries.
- III. Porter's Five Forces Model
  - A. This model was devised by Michael Porter to describe forces that shape competition within an industry and help to identify strategic opportunities and threats. The stronger each of these forces is the more established companies are limited in their ability to raise prices and earn greater profits. A strong competitive force is a threat because it depresses profits. A weak competitive force is an opportunity because it allows the company to earn greater returns.

*Figure 2.2: Porter's Five Forces Model*

- B. One of Porter's five forces is the risk of entry by potential competitors. **Potential competitors** are companies that are currently not competing in the industry but have the capability to do so. New entry into an industry expands supply. This in turn depresses prices and profits. Thus a high risk of new entry constitutes a strategic threat. A low risk of new entry allows established companies to raise their prices, therefore it constitutes an opportunity. The risk of entry by potential competitors is a function of the height of **barriers to entry**. The height of barriers to entry is determined by several factors.
1. **Economies of scale** arise when unit costs fall as a firm expands its output. Sources of economies include 1) cost reduction gained through mass-producing a standardized output; 2) discounts on bulk purchases of raw material inputs and component parts; 3) the advantages gained by spreading fixed production costs over a large production volume; and 4) the cost savings associated with spreading marketing and advertising costs over a large volume of output.
  2. The extent to which established companies have **brand loyalty** from their customers is one factor. Loyal customers would discourage potential competitors.
  3. Potential competitors are also discouraged when established companies enjoy an **absolute cost advantage** over potential entrants. Cost advantages might include factors such as patents, control of a specific raw material, or access to cheaper funds.
  4. When customer **switching costs**—that is, costs that accrue to a consumer that intends to switch from the product offering of an established company to the product offering of a new entrant—are high, potential new entrants are discouraged.
  5. **Government regulations**, such as establishing a protected monopoly, tend to protect established firms, and thus constitutes a barrier to entry. When industries are deregulated new entrants usually proliferate.

### Strategy in Action 2.1 Circumventing Entry Barriers into the Soft Drink Industry

The soft drink industry has long been dominated by two companies, Coca-Cola and PepsiCo. Both companies have historically spent large sums of money on advertising and promotion, which has created significant brand loyalty and made it very difficult for prospective new competitors to enter the industry and take market share away from these two giants. When new competitors do try and enter, both companies have shown themselves capable of responding by cutting prices, forcing the new entrant to curtail expansion plans.

However, in the early 1990s the Cott Corporation, then a small Canadian bottling company, worked out a strategy for entering the soft drink market. The company used a deal with RC Cola to enter the cola segment of the soft drink market. Cott next introduced a private label brand for a Canadian retailer. Both of these offerings took share from Coke and Pepsi. Cott then decided to try and convince other

retailers to carry private label cola. Cott spent almost nothing on advertising and promotion. These cost savings were passed onto retailers in the form of lower prices. For their part, the retailers found that they could significantly undercut the price of Coke and Pepsi colas, and still make better profit margins on private label brands than on branded colas.

Despite the savings, many retailers were leery of offending Coke and Pepsi and declined to offer a private label. Cott was able to establish a relationship with Walmart as it was entering the grocery market. The "President's Label" became very popular. Cott soon added other flavors to its offering, such as a lemon lime soda that would compete with Seven Up and Sprite. Moreover, pressured by

Walmart, by the late 1990s other U.S. grocers also started to introduce private label sodas, often turning to Cott to supply their needs.

By 2006, Cott had grown to become a \$1.8 billion company. Its volume growth between 2001 and 2006 in an otherwise stagnant U.S. market for sodas was roughly 12.5%. The largest private label company, Cott captured over 5% of the U.S. soda market in 2005, up from almost nothing a decade earlier. The losers in this process were Coca-Cola and Pepsi Cola, who were now facing the steady erosion of their brand loyalty and market share as consumers increasingly came to recognize the high quality and low price of private label sodas.

### Teaching Note:

As this case illustrates, entry barriers can be effective in discouraging new entrants; however, they can be circumvented. Cott was able to enter a much closed industry through a combination of its own efforts and the changes brought to the industry environment by the advent of Walmart. You can use this case in a classroom discussion to identify entry barriers in other industries. Another approach to classroom discussion is to ask students to consider the lessons that other industries might learn from Cott. What did the Cott do to lower entry barriers, and how could those tactics be used in another context?

- C. Another of Porter's five forces is **rivalry** among established companies. Strong rivalry tends to lower prices and raise costs, which constitutes a threat to established companies, whereas weak rivalry creates an opportunity to earn greater returns. The extent of rivalry among established firms depends on several factors.
1. One factor is industry competitive structure, which refers to the number and size distribution of companies within an industry. Structures vary from fragmented (made up of many small- and medium-sized companies) to consolidated (dominated by a small number of large companies). Different competitive structures have different implications for rivalry.
    - a) Many fragmented industries are characterized by low entry barriers and commodity-type-products that are hard to differentiate. These characteristics tend to result in boom-and-bust cycles, with a flood of new entrants, excess capacity, and price wars, leading to low industry profits and exit from the industry. The more commodity-like an industry's product, the more vicious the price war. The "bust" part of the cycle will continue until overall industry capacity is brought into line with demand (through bankruptcies), at which point prices may stabilize again.
    - b) Consolidated industries are interdependent, so that the competitive actions of one company directly affect the profitability of competitors, forcing a response from them. The consequence can be price wars like those the airline industry has experienced. Thus interdependence is a major threat. This threat can be reduced when tacit price-leadership agreements exist within the industry and when companies are successful in emphasizing nonprice competition.
  2. Demand conditions also determine the intensity of rivalry among established companies. Growing demand moderates competition by providing room for expansion. Declining demand results in more competition as companies fight to maintain revenues and market share.
  3. Cost conditions are another determinant of rivalry between firms. High fixed costs lead to a focus on volume of sales in order to cover these costs. This focus on volume can

spark intense rivalry if demand is weakening and too many firms are involved in providing the same products. This situation will prompt firms in the industry to lower prices in order to capture sufficient sales to cover costs.

### Strategy in Action 2.2 Price Wars in the Breakfast Cereal Industry

The breakfast cereal industry in the U.S. was one of the most profitable and desirable competitive environments, with steadily rising demand, brand loyalty, and close relationships with buyers (grocery retailers). Best of all, the industry was dominated by just three competitors, and one, Kellogg's, controlled 40% of the market share. Kellogg's was a price leader, raising prices a bit each year, and the smaller companies followed suit. Then the industry structure changed. Huge discounters began to promote cheaper private brands, just as bagels or muffins replaced cereal as the preferred breakfast food. Under pressure, the big manufacturers began a price war, ending the tacit price collusion that had kept the industry stable and profitable. Although profit margins were slashed in half, the big three continued to lose market share to private brands. What was once a desirable industry is now exactly like most others—competitive, unstable, and far less profitable.

### Teaching Note:

This case illustrates the sad outcomes that result when industry competitors react to increased pressure by breaking off tacit price collusion. You should be sure to emphasize to students the difference between *tacit price collusion*, which is indirect and therefore legal, and *price fixing*, which is overt and therefore illegal. Again, the message here is that a well-run industry, with sustained high profitability and stability for all competitors, fell victim to powerful external forces. An interesting discussion question would be to ask students, “Is there any action the big three competitors can take now to undo the damage and recover their profitability?” If students suggest any action that they believe will restore the situation, ask them how the other competitors would be likely to react. For example, if students suggest a one-sided price increase, ask them if competitors would be likely to follow suit. Students may be surprised to realize how difficult it is to “put the genie back in the bottle”; once trust is destroyed, an industry may never be able to recreate stability and prosperity.

4. Exit barriers are a serious competitive threat, especially when demand is declining. Economic, strategic, and emotional factors can keep companies competing in an industry even when returns are low. This in turn leads to excess capacity and price wars. Exit barriers include:
  - a) investments in specialized assets
  - b) high fixed costs of exit such as severance pay
  - c) emotional attachments to an industry
  - d) economic dependence on a single industry
  - e) the need to maintain expensive assets in order to compete effectively in that industry.

#### D. A third factor in Porter's five forces model is **the bargaining power of buyers**.

Buyers can be individual consumers, other businesses, wholesalers, or retailers. Buyers can be viewed as a competitive threat when they force down prices or when they raise expenses by demanding higher quality and better service. The ability of buyers to make demands on a company depend on their power relative to that of the company. Buyers tend to be powerful when:

1. they are in industries that are more highly consolidated than the company's industry
2. they purchase in large quantities or constitute a significant buyer for that industry

3. supply industry depends on the buyers for a large percentage of its total orders.
4. buyers can easily switch to a substitute product or an alternate supplier
5. when it is feasible for buyers to purchase an input from several companies at once
6. buyers can readily produce the product themselves

### Running Case Walmart's Bargaining Power over Suppliers

When Walmart and other discounter retailers got their start in the 1960s, they were small operations with little purchasing power. They depended on nationally branded merchandise to generate store traffic but were price takers and received few discounts from the manufacturers. They cut costs by emphasizing self-service stores in suburban locations. Discounters such as Kmart purchased their merchandise through wholesalers, who in turn bought from manufacturers. This option wasn't acceptable to Walmart due to its rural locations and the high fees wholesalers expected. Instead Walmart went public and used the capital to build a distribution center to stock merchandise for stores within a 300-mile radius. Because the distribution center was buying for a number of stores it was able to buy in larger volumes directly from the manufacturers. The cost savings were passed on to consumers in the form of lower prices. Walmart continued to grow, increasing its buying power and developing the ability to demand greater discounts from manufacturers.

Today 8% of all retail sales in the United States are made in a Walmart store, so the company has enormous bargaining power over its suppliers. People don't go to Walmart to buy branded goods; they go to Walmart for the low prices. This simple fact has enabled Walmart to bargain down the prices it pays, always passing on cost savings to consumers in the form of lower prices.

### Teaching Note:

The case discusses how Walmart's buying power has changed over the years as the company has become larger. You can ask students to describe how Walmart's buying power has increased over time and discuss how the actions reinforce one another.

- E. A fourth factor is **the bargaining power of suppliers**. Suppliers are any organization that supplies materials, services, or labor (such as labor unions) to the company. Suppliers are a threat when they are able to force up the price the company must pay for inputs or to reduce the quality of goods supplied. The ability of suppliers to make demands on a company depends on their power relative to that of the company. Suppliers tend to be powerful when:
  1. the supplier's product has no substitutes or is vital to the company
  2. the company is not important to the supplier
  3. the company has a switching cost to change suppliers
  4. suppliers can readily enter the company's industry
  5. the company cannot readily enter the supplier's industry
- F. A fifth factor is the threat of **substitute products**. The existence of adequate substitute products limit the price that companies in an industry can charge without losing their customers to makers of substitutes. The threat of substitutes tends to be greater when:
  1. the substitute is a close one, equally adequate in filling customers' needs
  2. the price of the substitute is equal to or less than the company's products
- G. Recently, Intel CEO Andy Grove proposed a sixth force: **complementors**, or companies that sell products that are used in addition to and along with the enterprise's own products. When there is a weak supply of complementary products, demand in the industry will be weak, and

revenues and profits will be low. The threat from a lack of complementors tends to be greater when:

1. few complementary products exist
2. the existing complementary products are not attractive to customers, due to high prices, inadequate features, and so on

#### Teaching Note: Ethical Dilemma

While discussion could enter into whether or not moral objections should influence analysis and recommendations, the real question should focus on whether or not casinos will be a complement to the industry. Will casinos bring value to the customers? Will casinos generate demand for the hotel industry?

#### IV. Strategic Groups Within Industries

- A. A **strategic group** is a group of companies within an industry that are pursuing the same basic strategy as the companies within the group but different strategies than those of companies outside the group. The strategies may be based on a variety of factors, such as differences in quality, market segment served, or distribution channel utilized. Normally, a limited number of strategic groups capture the essence of strategic differences among companies within an industry.

##### *Figure 2.3: Strategic Groups in the Pharmaceutical Industry*

- B. Strategic groups have several implications for internal analysis.
1. A company's immediate competitors are those in its strategic group. Because all companies in a strategic group are pursuing similar strategies consumers tend to view the products of such enterprises as direct substitutes for each other.
  2. Different strategic groups can have a different standing with respect to the threats and opportunities they face from each of Porter's five competitive forces. Some strategic groups are more desirable than others, characterized by a lower level of threats and/or by greater opportunities.
  3. **Mobility barriers** are factors that inhibit movement between groups. They are analogous to industry entry barriers and are based on the same factors: brand loyalty, absolute cost advantages, and economies of scale. Mobility barriers make it difficult for companies to move into another strategic group. They also protect group members from entry by companies from other groups.

#### V. Industry Life Cycle Analysis

- A. Over time, industries pass through a series of well-defined stages with different implications for the nature of competition. Porter's five competitive forces and competitive dynamics change as an industry evolves. Managers must learn to anticipate the changes that will occur as the industry develops over time.

##### *Figure 2.4: Stages in the Industry Life Cycle*

- B. An **embryonic industry** is one that is just beginning to develop. Growth is slow because of buyer unfamiliarity with the industry's products, poor distribution channels, and high prices stemming from the inability of companies to reap economies of scale.
1. Barriers to entry at this stage tend to be based on access to key technological know-how, rather than cost economies or brand loyalty. Rivalry in embryonic industries is based on educating customers, opening up distribution channels, and perfecting the design of the product.

2. Embryonic industries provide a good opportunity for firms to capture loyal customers, capitalizing on the lack of rivalry.
- C. A **growth industry** is one where first-time demand is expanding rapidly as new consumers enter the marketplace. Typically, demand takes off when consumers become familiar with the product, prices fall with the attainment of economies of scale, and distribution channels develop.
  1. During an industry's growth stage, there tends to be little rivalry. Rapid growth in demand enables companies to expand their revenues and profits without taking market share away from competitors.
  2. Growth industries provide opportunities for firms to expand their market share and revenues in a relatively low rivalry situation. Firms entering at this stage avoid the high expenses of initial product development.
- D. An **industry shakeout** occurs when the rate of industry growth slows down as demand approaches saturation levels. A saturated market is one where there are few first-time buyers left. Most of the demand is limited to replacement demand.
  1. As an industry enters the shakeout stage, rivalry between companies becomes intense, with excess productive capacity and severe price discounting. Many firms exit the industry at this point.
  2. Industry shakeout provides an opportunity for those firms that are dedicated to success in this particular industry to consolidate their power, often by acquiring the assets of firms exiting the industry.

*Figure 2.5: Growth in Demand and Capacity*

- E. A **mature industry** is one where the market is totally saturated, growth is very low or near zero, and demand is limited to replacement demand. Most competitors have exited the industry, creating an oligopoly dominated by a few large companies.
  1. As an industry enters maturity, barriers to entry increase and the threat of entry from potential competitors decreases. Intense competition for market share can develop, driving down prices.
  2. In mature industries, companies tend to recognize their interdependence and try to avoid price wars if possible. Stable demand gives them the opportunity to enter into price-leadership agreements, reducing the intensity of rivalry and allowing greater profitability. However, the stability of a mature industry is always threatened by further price wars, especially in an economic downturn.
- F. In the **decline stage**, growth becomes negative. Virtually all companies exit the industry.
  1. Depending on the speed of the decline and the height of exit barriers, competitive pressures can become as fierce as in the shakeout stage.
  2. Falling demand leads to excess capacity, causing companies to engage in price wars. The greater the exit barriers, the harder it is for companies to reduce capacity and the greater is the threat of severe price competition.
- VI. Limitations of Models for Industry Analysis
  - A. The five forces, strategic groups, and industry life cycle models constitute very useful ways of thinking about and analyzing the nature of competition within an industry. However, these models have limitations. It does not mean the models are useless. It does mean, however, that managers must be aware of the limitations as they apply these models to their firms.
  - B. One important limitation of the life cycle model is that industry life cycles vary considerably, skipping or repeating stages, moving slowly or rapidly through the stages, or remaining "stuck" at a particular stage.



- C. Another limitation of all of these models is the lack of attention paid to the consequences of innovation. Over time, innovation in many industries leads to new products, processes, or strategies that can be very successful and transform the nature of competition within an industry. Innovation can fragment or consolidate an industry, create new strategic groups or market segments, speed or slow an industry's life cycle, and otherwise disrupt the orderly predictions of all three of the models for industry analysis.
1. Michael Porter, the originator of the five forces model, has recently shifted focus to acknowledge the role of innovations as “unfreezing” and “reshaping” industry structure. Porter describes a model of punctuated equilibrium, in which an innovation triggers a period of turbulence, followed by a period of stability. The punctuated equilibrium theory allows Porter's five forces model to continue to be somewhat useful, in spite of limitation. This theory asserts that the five forces model is not a good predictor of the changes that take place in the short time just after an important innovation, but it is useful in the longer periods of stability that follow the turbulence.

*Figure 2.6: Punctuated Equilibrium and Competitive Structure*

2. However, there are those who question the validity of the punctuated equilibrium approach. Dr. Richard D'Aveni has argued that many industries are **hypercompetitive**, and are characterized by permanent and ongoing innovation. In hypercompetitive industries, industry structure is constantly being revolutionized by innovation; there are no periods of equilibrium. Thus, the three models of internal analysis are not useful.
- D. Another limitation of the models for internal analysis is the lack of attention paid to firm-specific factors. Studies point to enormous variance in the profit rates of individual companies within an industry, with industry effects accounting for only 10 to 20% of the variance. These studies suggest that the individual resources and capabilities of a company are far more important determinants of that company's profitability than the industry or the strategic group of which the company is a member.
- VII. The Macroenvironment
- A. The **macroenvironment** refers to the broader economic, technological, demographic, social, and political environment within which an industry is embedded. It is apparent that changes in this macroenvironment can have a direct impact on any one of the five forces in Porter's model, thereby altering the relative strength of these forces and, with it, the attractiveness of an industry.
  - B. There are five important forces in the macroenvironment.

*Figure 2.7: The Role of the Macroenvironment*

1. **Macroeconomic forces** include changes in the growth rate of the economy, interest rates, currency exchange rates, and inflation rates; these are all major determinants of the overall level of demand. Adverse changes in any of these can threaten profitability in an industry, whereas positive changes tend to increase profitability.
2. **Global forces** include globalization of production and markets. Industry boundaries no longer stop at national borders and competitors can come from other national markets, increasing rivalry. Globalization can also provide opportunities for new markets for national firms.
3. **Technological forces** are characterized by an accelerated pace of innovation and change. Technological change can make established products obsolete overnight, but at the same time, it can create new products and processes. Thus technological change is both an opportunity and a threat; it is creative and destructive.

4. **Demographic forces** consist of any trends related to population, such as the aging of the U.S. population and the movement of people across national boundaries. Changing demographics create both opportunities and threats, spawning new industries and products while eliminating others.
5. **Social forces** consist of changes in societal preferences and values. New social movements also create opportunities and threats. For example, the impact of the trend toward greater health consciousness has been a boon to the fitness equipment and organic foods industries, while it has hurt the beef and cigarette industries.
6. **Political and legal forces** are shaped by changing laws and regulations. Factors such as deregulation, insurance reform, and even the political party makeup of Congress can create opportunities and threats for companies in many industries.

## ANSWERS TO DISCUSSION QUESTIONS

1. Under what environmental conditions are price wars most likely to occur in an industry? What are the implications of price wars for a company? How should a company try to deal with the threat of a price war?

Price wars are most likely to occur when the following conditions are present in an industry: the product is a commodity, exit barriers are substantial, excess capacity exists, the industry is consolidated, and demand is declining. A price war constitutes a strong threat. It is difficult for companies that market commodity-type products to build brand loyalty; therefore, competition tends to focus on price. High exit barriers make it hard for companies to eliminate excess capacity through plant closings. In turn, the persistence of excess capacity leads to price cuts, as companies strive to generate enough demand to utilize their ideal capacity and cover fixed costs. In a consolidated industry, interdependence implies that one company's price cuts will elicit a response from its rivals, producing a downward spiral of prices. And it is declining demand that produces excess capacity and sparks off a price war in the first place. If all these conditions are present a severe price war is likely.

Survival depends on a company's ability to reduce operating costs and build brand loyalty so that it can retain its customers and still make profits when those of its competitors have dried up. Furthermore, the risk of a damaging price war can be reduced if the company can successfully enter into tacit price agreements with its competitors and if it can stress nonprice factors when competing. As demand declines, however, tacit price agreements can be difficult to maintain. Finally, if excess capacity is the major reason for a price war, capacity reduction agreements between competitors, or mergers between competitors followed by the elimination of excess capacity, may be suitable strategies for attacking this problem.

2. Discuss Porter's five forces model with reference to what you know about the steel industry. (see the Opening case). What does the model tell you about the level of competition in this industry?

*Potential competitors:* Recent high profitability and an enormous surge in demand for steel worldwide, there may be room for new entrants. Barriers to entry include the high cost of plant and equipment, raw materials and labor, and the uncertainty of economic stability, the strength of the U.S. dollar, and governmental regulation. There are numerous and emerging substitutes such as aluminum, plastics, and composites. Economies of scale are available to the only the largest producers.

*Rivalry among established companies:* Rivalry between the existing mass market steel industry producers is intense; however, investment in infrastructure by developing countries, notably China, has driven demand to the point where price and profitability have shown strength.

*Bargaining power of buyers:* Consumers have little power in the steel industry. However, when substitutes are available they are able to bargain down prices as was done historically in the industry.

*Bargaining power of suppliers:* Steel industry suppliers deal mostly in commodities and therefore, have little power in the industry. Suppliers are also threatened by potential and existing substitutes.

*Threat of substitute products:* Substitutes for the steel industry include aluminum, plastics, and composites. Also, a trend toward environmentally-conscious substitutes may affect this industry and the demand for steel in the future.

In sum, the five forces model suggests that the overall intensity of competition in the steel industry would remain tight while leaving little opportunity for profitable new entrants. While the steel industry appears profitable in an economic downturn, it appears to be driven mainly by governmental agendas regarding infrastructure rebuilding.

3. Identify a growth industry, a mature industry, and a declining industry. For each industry, identify the following: (a) the number and size distribution of companies; (b) the nature of barriers to entry; (c) the height of barriers to entry; and (d) the extent of product differentiation. What do these factors tell you about the nature of competition in each industry? What are the implications for the company in terms of opportunities and threats?

Students' answers will vary depending on the companies they select. For example, growth industries might include the personal computer industry, the computer software industry, and the nursing home industry. Mature industries include the auto industry, the airline industry, and the beer industry. Declining industries include the tobacco industry, the sugar industry, and the steel industry.

Growth industries tend to have many firms and be relatively fragmented. Barriers to entry may center on access to technological know-how, but overall, are low. Product differentiation also tends to be relatively low. Mature and declining industries have fewer firms and are more consolidated than growth industries. In addition, they have much higher barriers to entry, in the form of cost economies and brand loyalties. Product differentiation in mature and declining industries becomes much greater as an industry approaches maturity.

These changes reveal that the nature of competition in an industry also changes as the industry moves from growth through maturity and into decline. Specifically, a growth industry is characterized by relatively benign competitive pressures. Mature industries are characterized by an emphasis on nonprice competition as a means of avoiding damaging price wars, although price wars may break out from time to time. Competition in a declining industry depends on the speed of decline and the height of exit barriers. The faster the decline and the higher the exit barriers, the more intense is the competition within a declining industry.

In summary, the availability of opportunities decreases and the intensity of competitive threats increases as an industry passes from growth through maturity and into decline.

4. Assess the impact of macroenvironmental factors on the likely level of enrollment at your university over the next decade. What are the implications of these factors for the job security and salary level of your professors?

The most significant macroenvironmental factor here is to be found in the demographic environment. In the 1980s and early 1990s, many universities experienced a decline in enrollments due to the declining birthrate in the 1960s and 1970s. Starting in the late 1990s,

however, enrollments have risen as a result of the “baby boomlet” that occurred when the children of the Baby Boomers entered their late teen years. Rising enrollments have led to increased demand for higher education, with the resulting shortages. Universities are now able to increase their admission standards and smaller, regional schools are absorbing some of the excess demand. In addition, the economic downturn has led to an increase in older students returning to school for degrees, especially in business and other professions. On the negative side, legislative spending is lower, because state tax revenues are less. Universities are thus stuck in the position of trying to increase offerings while also reducing costs. Many colleges are responding by hiring more faculty but paying less, which they can accomplish by increasing the number of temporary, adjunct, or graduate student faculty members.

## PRACTICING STRATEGIC MANAGEMENT

### SMALL-GROUP EXERCISE: COMPETING WITH MICROSOFT

Students are asked to break into small groups, develop a solution, and then present their solution to the class. The exercise requires the students to assume a role as an engineer or manager at a small computer software firm that has developed an operating system that could rival Microsoft’s Windows software. The students are asked to analyze the competitive structure in the market for personal computer operating systems, using Porter’s five forces model and the sixth competitive force—complementors. Based on their competitive analysis, they should identify what factors might inhibit adoption of the operating system by customers. The group is also asked to identify a strategy that might be used to compete successfully against Microsoft, based on what they have learned about the competitive environment and to determine what it will take to execute the strategy successfully.

#### Teaching Note:

This case will serve as a powerful illustration to students that even the best product will not succeed in a severely hostile environment. Although some of the five forces are favorable in this case—low power of buyers, lack of substitutes—others are extremely negative, such as the very high barriers to entry and the intense rivalry. However, the most important factor is the lack of complementors. Students will discover that, even though the innovative operating system is superior to Microsoft’s Windows, without complementing software (e.g. word processing, spreadsheet, graphics, database), the new operating system will have no chance to succeed. Software developers will have no incentive to write for this new operating system, and without sufficient software, the product will fail to gain a foothold in the industry.

Thus, the strategic goal of the start-up should be to create an as large as possible installed base of computers using its operating system. The start-up can either decide to give the operating system away for free or sell it for a nominal fee to original equipment manufacturers like Compaq in the hope that software developers will start writing software for this new operating system. On the other hand, given that Microsoft has all the necessary complementary assets in house, it might be wiser for the start-up to cooperate with Microsoft.

### ARTICLE FILE 2

Students should find an example of an industry that has become more competitive in recent years. They should identify the reasons for the increase in competitive pressure.

#### Teaching Note:

Completion of this exercise will help students to see that the intensity of competition is increasing in most industries. They should have no trouble identifying industries with increasing competition.

Reasons for the increased competition are many. First, many of the factors mentioned in Porter's five forces model are changing across many industries in ways that will increase competition. For example, the U.S. and many other national governments are reducing industry regulation, lowering barriers to entry and opening up industries that were formerly monopolistic to competition. International regulation is also decreasing, raising competitive intensity for multinational firms. Another change is the consolidation that resulted from the merger-and-acquisition fever of the 1980s and 1990s. Higher consolidation has led to increased competition. Higher consolidation in the buyer and supplier industries, such as the increased power of giant discount retailers, has also put competitive pressure on many firms. Second, industries, especially in developing countries, are starting to mature, which tends to increase competitive intensity.

## STRATEGIC MANAGEMENT PROJECT: MODULE 2

This module requires students to analyze the industry environment in which their companies are based, in order to reinforce the concepts about industry analysis that are presented in this chapter.

### Teaching Note:

Because this is the first module of the strategic management project that requires the gathering of a great deal of information, you should ensure that students are able to access sufficient data to perform a detailed analysis of their firm's external opportunities and threats.

Students may tend to rush through this section of the strategic management project because it appears to be a fairly mechanical exercise in information gathering. However, students should be encouraged to do a thorough and careful job in this section for three reasons. First, this analysis, along with the analysis of strengths and weaknesses that will be performed in Chapter 3, serves as the foundation for all of the remaining sections of the project. A poor job in this section will make it very difficult to do well in future assignments. Second, a hurried project may not aid students in understanding the concepts of the chapter in detail. For example, there are five major components to Porter's model, and each consists of several sub-components, each of which must be analyzed individually in order to provide an accurate overall assessment. Third, you can point out to students that this section is not merely a mechanical exercise, but also involves higher-level analytical skills. The students must gather data, *and* they must interpret that data. In particular, deciding whether a specific fact conveys more of a threat or more of an opportunity can be challenging and requires some careful thought. What threatens one industry may benefit another. For example, the aging population has constituted a threat for baby food manufacturers, but it has proven to be a boon for the home nursing care industry.

It is also important in this section that students use as many different analytical tools as possible, including Porter's five forces and complementors, strategic groups, and macroenvironmental analysis. You should emphasize to students that each of these tools provides a different type of insight such as the dynamics of the industry, stage of the life cycle in the industry, global expansion initiatives, and national context to a firm's managers, and that use of every available tool will provide the most well-rounded and realistic picture of the industry.

## CLOSING CASE

### *THE UNITED STATES BEER INDUSTRY*

The United States beer industry is characterized by an increase in the concentration of the market. With U.S. beer production being provided by just three companies, the mass market segment of the industry

revolves around competitive pricing, brand loyalties, distribution channels, and national advertising spending. The industry tends to be dominated by large established enterprises that have the scale required to bear the considerable costs and risks associated with developing new products and, moreover, can afford to spend large amounts of money to promote those products in the marketplace. There are opportunities for these firms in terms of new wines and spirits as well as threats from premium beer brewers.

### Teaching Note:

This case introduces many of the themes of Chapter 2, including the impact that competitive forces have on industry behavior and profitability, concepts about market segmentation and strategic groups, and the changing nature of competition over an industry's life cycle. One of the most important lessons of this chapter and this case, and one that may be somewhat surprising to students, is the very strong influence that external environments can have on firm performance. Much of what is discussed in the popular business literature focuses on the achievements or shortcomings of individual managers and other forces internal to the firm. But it is worthwhile to remind students that external forces can have just as much impact and can even cause the demise of firms with competent managers.

## ANSWERS TO CASE DISCUSSION QUESTIONS

1. Why has the United States brewing industry become more concentrated over the last two decades?

The concentrated market is due to consolidation (acquisitions and mergers, primarily), mass marketing techniques including increased national advertising budgets, aggressive pricing, and emphasis on development of brand loyalty.

2. Analyze the competitive structure of the industry using Porter's competitive forces model.

*Risk of Entry:* The industry tends to be dominated by large established enterprises that have the scale required to bear the considerable costs and risks associated with developing new beers and, moreover, can afford to spend large amounts of money to promote those beverages in the marketplace. New entrants face a steadily increasing minimum efficient scale of production, meaning that more and more product is required to achieve any economies of scale.

*Rivalry among established companies:* Rivalry is high evidenced by the small number of competitors, aggressive price competition, and intense brand competition. The top two or three firms account for 80% of the industry sales. When one company introduces a new product, service, or program, the others are forced to respond. Demand conditions are weakening due to increased sales of premium beers, wine, and spirits, and cost conditions remain high. This further intensifies rivalry as costs go up and profits narrow.

*Bargaining power of buyers:* Where large corporations and distributors can force price concessions, this can be considered a threat in the beer industry. Consumers themselves have a high level of bargaining power as they can be particularly price-sensitive without intense brand loyalty.

*Bargaining power of suppliers:* Most raw materials in the beer-making process are commodities so there is little bargaining power of suppliers in this industry.

*Substitutes:* Many substitutes are in existence for mass-market beer, such as micro-brewed beer, wine, and spirits.

The cumulative effect of these five forces is that the mass-market beer industry can be considered an oligopoly or a dominated profitable industry in its mature stage. The stability of a mature industry like this is always threatened by further price wars.

3. What are the implications of the evolving competitive structure in the brewing industry for the profitability and strategy of a smaller mass market firm in the industry?

The premium beer segment is an opportunity for the smaller firm but once it is imitated by a powerful established company such as Anheuser Busch, they only, at present, have the resources to accelerate such placement in the market.

4. Are there different strategic groups in the industry? What are they?

Proprietary groups include the mass market segment served by Anheuser Busch and SAB-Miller Molson Coors, and the premium beer segment served by micro breweries and importers.

Do you think the nature of competition varies among groups?

The nature of competition will vary widely as the former is a mature industry and the latter a growth industry. The number of competitors is much greater in the premium beer segment and rivalry is lower. Product differentiation is high and demand conditions are favorable as each brewery markets to an exclusive, discerning buyer group. Price competition is not as intense and the use of targeted marketing strategies is more prevalent.

## CASE 2

# BALLY TOTAL FITNESS

### SYNOPSIS OF THE CASE

The case looks at the structure of the US Health Club industry. In addition, it provides details of the history and growth of one of the major players in the health club industry, Bally Total Fitness. The case traces the rapid growth of the health club industry, as well as its competitive landscape and potential. While the industry is extremely fragmented and competitive, Bally Total Fitness has built a widely recognized brand name and grown via acquisitions and a variety of marketing and operational tactics. Bally Total Fitness' current CEO, Paul Toback has some decisions to make about how to grow Bally Total Fitness in the future and provide a service that can stand out in an extremely competitive industry. This is important to provide confidence to investors – Bally Total Fitness' collapsed stock price suggests that investors do not have confidence in its strategy.

### TEACHING OBJECTIVES

1. To understand the structure of health club industry.
2. To evaluate Bally Total Fitness' historical strategy.
3. To discuss and develop options for Bally Total Fitness at a business level that provide it a good chance to survive and grow in a competitive industry.

The case works very well with material covered in chapters involving internal and external analysis, as well as business level strategy of differentiation.

### STRATEGIC ISSUES AND DISCUSSION QUESTIONS

**How is the health club industry structured? What are the key success factors?**

The health club industry can be analyzed using Porter's five forces model:

1. Intensity of competition. The intensity of competition is high. There are many competitors of all sizes, suggesting that it is relatively easy to enter the industry and there are few economies of scale. Most efforts to build differentiation are imitated rapidly – as



## Case 2: Bally Total Fitness

a result, customers have little reason to be loyal to any particular health club. The customer acquisition and retention costs are high, which cuts into margins. Customers resist signing long-term contracts. The good news is that the industry still has a lot of room to grow.

2. Threat from potential competition is moderately high. The entry barriers are rather low – low economies of scale (stand-alone health clubs can operate as well as chains), low brand loyalty (low differentiation), low absolute capital cost (compared to many other industries – equipment and property could be leased) increase the threat from potential competition. The switching costs are rather low, and consumers resent being locked-up into long-term contracts.

3. Threat from substitutes is very high. There are many substitutes, including home-gyms, hotel facilities, other ways and methods to get exercise.

4. Bargaining power of customers is moderate. While customers don't negotiate as a group, they have relatively low switching costs (they do get locked in for the contract period, but there are also many promotional discounts available). However, customers may get used to the layout and the facilities of a particular gym, which may increase their switching cost. Some customers can vertically integrate by developing home gyms with their favorite equipment – however, it is hard to duplicate the social aspects, as well as the extensive facilities of a full-service health club.

5. Bargaining power of suppliers is low. There are only a few suppliers of exercise equipment, and they frequently innovate and develop new systems. In their desire/attempt to differentiate, the health clubs are susceptible to heavy marketing by the equipment suppliers, and therefore may be vulnerable on prices. The labor cost is not a significant factor however.

Key success factors in the industry are the location of the property, the degree to which customers refer other customers to the property, the quality of the staff and facilities, and the degree to which customers can be retained by the facility.

### **How sensitive is the industry to business cycles?**

The industry is moderately susceptible to business cycles. In tough times, customers may switch to cheaper ways to get their exercise. However, some customers may believe that exercising is as basic as food and shelter, and may cut back on other discretionary expenses (such as vacation travel and entertainment) before cutting back on the health club expenses – these would be the core customers, that constitute a significant proportion of customers who use the health club.

**Are there any strategic groups in the industry and what are their distinctive features?**

There are a few strategic groups in the industry. The owner operated national chains emphasize consistency, membership portability, and quality of clients and staff. They compete most directly with franchised clubs. At other extreme are stand-alone clubs that emphasize neighborhood style friendly, personalized service. They face higher costs because of lower bargaining power with suppliers, so they may not upgrade the equipment as frequently as the first group. Design and management companies operated the health club facilities for corporate clients (such as hotels, universities, etc.) for a fee. Their customers are corporations, and not individuals. And finally, the spa group enveloped the health club concept with relaxation and extended stay hospitality services, suitable more to relax, rejuvenate, and get pampered.

**What has been Bally Total Fitness' historical strategy?**

Bally Total Fitness has suffered from an inconsistent, unfocused strategy. The organization was aggressive in horizontal integration with acquisitions of other fitness chains. These chains were bought purely because of financial reasons (e.g. their cash flows justified the price paid). Its business-level strategy was not clear in terms of cost or differentiation, evident by the disparity in the kind of chains that were bought – e.g. the upscale Pinnacle Fitness, and the no-frills Gorilla Sports. The next step of developing a coherent business level strategy seems to be lacking. Bally Total Fitness grew largely by acquiring additional properties. Furthermore, these acquisitions were paid for by debt, which tied managers' options in terms of taking risk in strategy – the company needed the cash flow to service the debt.

While expanding the number of locations via debt, Bally Total Fitness management also expanded the range of products – e.g. food and equipment. These generated additional revenues (\$150 million in 2003, about 16% of total revenues), but may have also distracted the management from perfecting and differentiating their core business.

**What are some of Bally Total Fitness' key strengths?**

Bally Total Fitness has good brand recognition and a national presence. Under Toback, Bally Total Fitness has a leader who is serious about building and growing the organization. The goal of improving the product and making it more relevant to customers is one of customer responsiveness, a key factor in competitive advantage building. Its facilities are well-regarded even though they offer inconsistent amenities (e.g. racquetball courts and pools are not offered everywhere). Club managers, who were formerly developed as general managers rather than sales managers, will now be more hands-on, focusing on customer needs and employee training, retention, and development.

Case 2: Bally Total Fitness

**What are some of CEO Toback's most pressing concerns and how could he go about addressing them?**

Toback has to focus on further differentiation of the product, since the market is very competitive, and many new features are easily imitated. Increased personalization (e.g. nutritional and exercise program tailored to each customer) may help in customer retention and enhance differentiation. However, it also will require investment in specialized assets, since nutrition advice/services will require specialized personnel. Customers also have other sources for nutrition counseling, and unless Bally can make credible investment in this area, it may only be a superficial fix.

Toback also has to worry about being closer to customers. Its core customer base may be struggling to find the time to use a health club. Also, a few companies have begun to offer health club facilities on their own campuses, as a perk, and also to encourage employees to lead healthier lives (and lower the corporation's healthcare expenses). Toback can be aggressive in seeking corporate business, and Bally Total Fitness can offer to run the health club facilities for corporations. This is a lucrative area, since customer retention is not an issue, and Toback may be able to experiment more with the product in a relatively safe corporate environment.