

Strategy: Core Concepts and Analytical Approaches

Arthur A. Thompson, The University of Alabama

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chapter 3

Evaluating a Company's External Environment

Analysis is the critical starting point of strategic thinking.

—Kenichi Ohmae, consultant and author

Things are always different—the art is figuring out which differences matter.

—Laszlo Birinyi, investments manager

In essence, the job of a strategist is to understand and cope with competition.

—Michael E. Porter, Harvard Business School professor

No matter what it takes, the goal of strategy is to beat the competition.

—Kenichi Ohmae, consultant and author

In order for managers to act wisely in steering a company in a different direction or crafting a strategy, they must first have a deep understanding of the pertinent factors surrounding the company's situation. Two facets of a company's situation are especially relevant: (1) the industry and competitive environment in which the company operates and the forces acting to reshape this environment, and (2) the company's own market position and competitiveness—its resources and capabilities, its strengths and weaknesses vis-à-vis rivals, and its windows of opportunity.

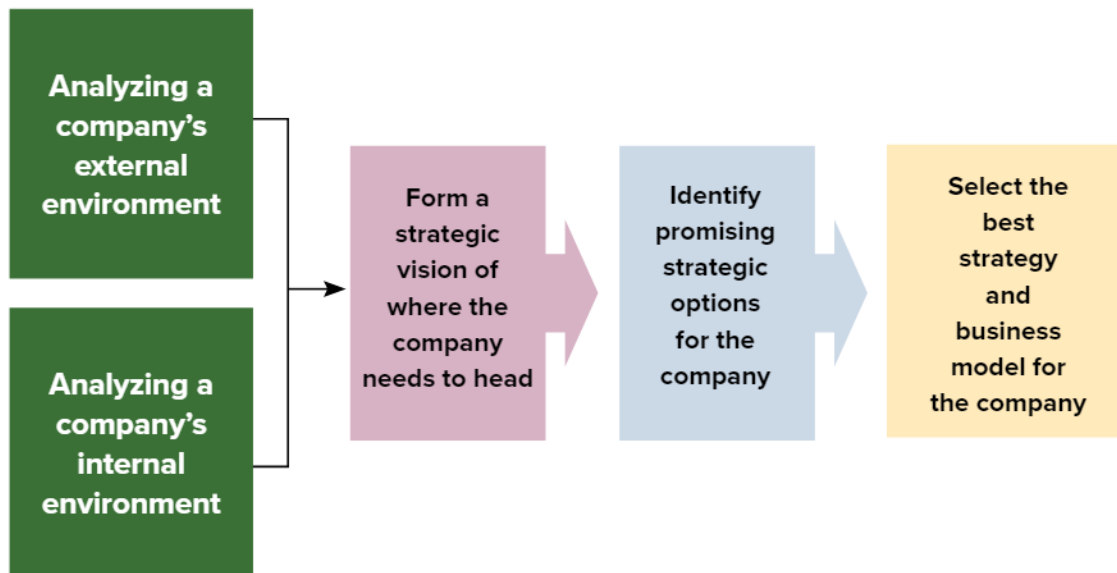
In order to wisely chart a company's strategic course, managers must first develop a deep understanding of the company's present situation. Two facets of a company's situation are especially relevant: (1) the industry and competitive environment in which the company operates and the forces acting to reshape this environment, and (2) the company's internal environment—its resources and capabilities, its strengths and weaknesses vis-à-vis rivals, and its windows of opportunity.

Insightful diagnosis of a company's external and internal environment is a prerequisite for managers to succeed in crafting a strategy that is an excellent fit with the company's situation, is capable of building a competitive advantage, and has good prospects for boosting company performance—the three criteria of a winning strategy. As depicted in Figure 3.1, the task of crafting a strategy begins with appraisals of the company's external and

internal environments (as a basis for deciding upon a long-term direction and developing a strategic vision), moves toward an evaluation of the most promising alternative strategies and business models, and culminates in choosing a specific strategy.

This chapter presents the concepts and analytical tools for zeroing in on those aspects of a single-business company's external environment that should be considered in making strategic choices. Attention centers on analyzing the broad aspects of the company's "macro-environment," the specific market arena in which the company operates, the drivers of market change, the market positions and likely actions of rival companies, and the factors that determine competitive success. In Chapter 4, we explore the analytical methods of evaluating a company's internal circumstances and competitive capabilities.

Figure 3.1 From Analyzing the Company's Situation to Choosing a Strategy



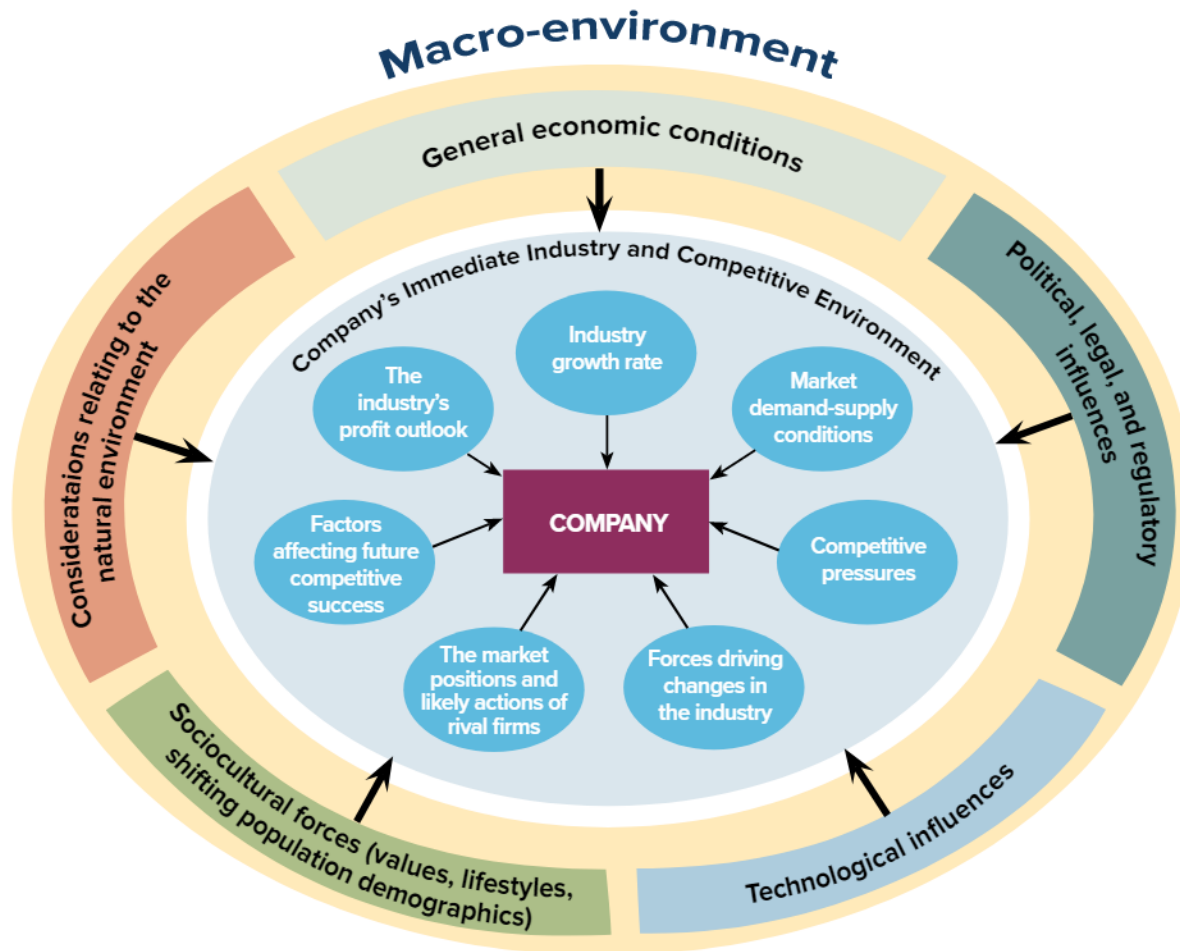
The Strategically Relevant Factors Influencing a Company's External Environment

Every company operates in a broad macro-environment shaped by influences relating to national and/or global economic conditions; political, legal, and regulatory factors; technological factors; sociocultural factors (societal values, lifestyles, and shifting population demographics); considerations relating to the natural environment; and, closer to home, the industry and competitive arena in which the company operates (see Figure 3.2). Strictly speaking, a company's macro-environment includes *all factors and influences* outside the company's boundaries that are *strategically relevant* enough to have a bearing on the decisions the company ultimately makes about its direction, objectives, strategy, and business model.

When new developments occur in the outer ring of the macro-environment with or without warning, the impact of their resulting influences on a company's business can range from big to small and occur slowly or rapidly. It is typical for different industries—and often different companies within the same industry—to be affected in different ways and to different degrees. Moreover, even though there may be multiple signs that certain outer-ring macro-environmental factors are undergoing change, it is frequently difficult to quickly discern what the resulting influences will be and the size and nature of the impact these influences will have. But despite the

difficulties, there can be no doubt that company managers need to keep a watchful eye on the macro-environment. It is an important managerial responsibility to scan the external environment for potentially important outer-ring developments, assess their impact and influence, and adapt the company's direction and strategy as needed.

Figure 3.2 The Components of a Company's Macro-environment



For example, when stringent new federal banking regulations pertaining to lending risk and lending requirements are announced and take effect, the affected banks must rapidly adapt their strategies and lending practices to be in compliance. Cigarette producers must adapt to anti-smoking ordinances, the decisions of governments to impose higher cigarette taxes, the cultural stigma attached to smoking, and newly-emerging e-cigarette technology. The homebuilding industry is affected by such macro-influences as trends in household incomes and buying power; rules and regulations that make it easier/harder for homebuyers to obtain mortgages; changes in mortgage interest rates; shifting preferences of families for renting versus owning a home; shifts in buyer preferences for homes of various sizes, styles, and price ranges; and changing preferences for particular kinds of home features—most homebuilders watch such developments and trends closely, making frequent adjustments in home sizes, styles, and features. Companies in the food processing industry must assess the impact and influence of changing consumer attitudes toward processed foods laden with chemical ingredients, growing consumer preferences for natural and organic foods, and heightened public concerns about nutrition, healthy-eating, and obesity/diabetes risks—and adapt their long-term direction, performance targets, business model, and strategies in ways they deem appropriate.

Table 3.1 provides brief descriptions of the five components in the outer ring of the macro-environment, along with examples of the industries or business situations they can affect.

However, the factors and forces in a company's external environment having the *biggest* strategy-shaping impact typically pertain to the company's own industry and competitive environment—these include industry growth, competitive pressures, anticipated actions of rivals, forces driving industry change, the key factors for future competitive success, and the industry's outlook for profitability (as depicted in *the inner ring* of Figure 3.2). Consequently, the primary role of this chapter is to present a revealing discussion and analysis of the factors shaping a company's industry and competitive environment.

Table 3.1 The Five Outer-Ring Components of a Company's Macro-Environment

Component	Description
General economic conditions	Concerns the general economic climate and such specifics as the rate of economic growth, trends in per capita income and discretionary income, the inflation rate, the unemployment rate, interest rates and the availability of credit, consumer confidence, exchange rates, trade deficits or surpluses, and conditions in the stock market, bond market, and the real estate market. Industries like steel, construction, and buildings materials benefit from big increases in government spending on infrastructure (roads, bridges, airports, hospitals, schools) and a booming economy that features construction of new manufacturing plants, commercial buildings, and apartment complexes. Discount retailers and budget-priced restaurants benefit when general economic conditions weaken, as consumers become more price conscious and careful about how much they spend.
Political, legal, and regulatory influences	Pertinent political, legal, and regulatory factors include (1) whether government officials are friendly or openly hostile to businesses; (2) whether the political climate is conducive to raising/lowering taxes or tougher/more lenient regulation or increasing/decreasing government spending; and whether government is using import tariffs and border adjustment taxes to protect domestic companies and from what is deemed as unfair trade agreements with foreign countries. The extent to which politicians are inclined to intervene in the economy and impose a host of burdensome laws and regulations on companies in certain industries and/or grant subsidies to companies/industries deemed worthy of special government support are often industry specific. Minimum wage legislation largely impacts low-wage industries that employ substantial numbers of relatively unskilled workers. Companies in coal-mining, meat-packing, and steel-making where many jobs are hazardous or carry high risk of injury are much more impacted by occupational safety regulations than are companies in retailing or software programming.
Technological influences	The most important technological factors concern the pace of technological change and so-called breakthrough technical innovations that have the potential for wide-ranging effects on society, such as genetic engineering, self-driving vehicles, solar energy technology, artificial intelligence and 5G internet speeds. Technological changes can spawn the birth of altogether new industries (Internet retailing, drones, smart phones, connected wearable devices), disrupt others (cloud computing, mobile payments, 3-D printing, big data solutions), and render others obsolete (VCRs, fax machines, dial-up Internet connections).
Sociocultural influences (values, lifestyles, and shifting population demographics)	Sociocultural forces concern the nature and range of values, attitudes, beliefs, cultural influences, and lifestyles that impact demand for particular goods and services, as well as demographic factors such as population size, growth rate, and age distribution. An example of sociocultural influences is the trend toward healthier lifestyles, which can shift spending toward exercise equipment and health clubs and away from snack foods. The demographic effect of people living longer lives is having a huge impact on the health care, recreation, travel, hospitality, and entertainment industries. Growing consumer preferences for healthy, less-caloric menu choices that include vegetarian and gluten-free selections, organic and pasture-fed meats, and organic and/or locally grown fruits and vegetables are prompting fine dining and other restaurants to adapt their menus, recipes, and cooking practices.
Considerations relating to the natural environment	The relevance of environmental considerations stems from the fact that some industries contribute more significantly than others to air and/or water pollution or to the depletion of irreplaceable natural resources, or to inefficient energy/resource usage, or are closely associated with other types of environmentally damaging activities (unsustainable agricultural practices, the creation of waste products that are not recyclable or biodegradable). Growing numbers of companies worldwide, in response to stricter environmental regulations and also to mounting public concerns about the environment, are implementing actions to operate in a more environmentally and ecologically responsible manner.

Assessing a Company's Industry and Competitive Environment

To gain deep understanding of a company's industry and competitive environment, managers do not need to gather all the information they can find and spend lots of time digesting it. Rather, the task can be focused on using some well-defined concepts and analytical tools to get clear answers to six questions:

1. What competitive forces do industry members face, and how strong are they?
2. What forces are driving changes in the industry, and what impact will these changes have on competitive intensity and industry profitability?
3. What market positions do industry rivals occupy—who is strongly positioned and who is not?
4. What strategic moves are rivals likely to make next?
5. What are the key factors for future competitive success?
6. Is the industry outlook conducive to good profitability?

Analysis-based answers to these questions provide managers with essential understanding needed to craft a strategy that fits the company's external situation. The remainder of this chapter is devoted to describing the methods of obtaining solid answers to these six questions and explaining how the nature of a company's industry and competitive environment has direct bearing on company managers' strategic choices.

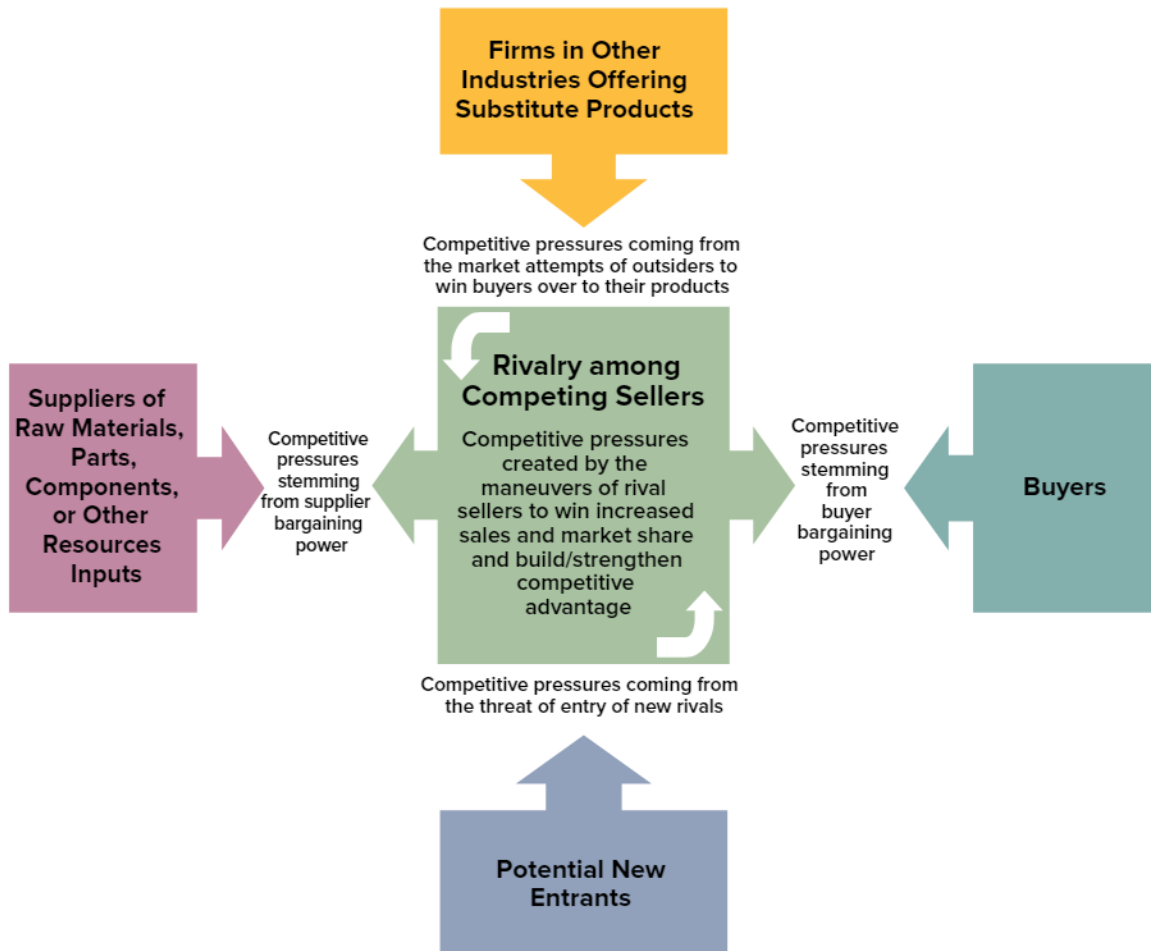
Question 1: What Competitive Forces Do Industry Members Face and How Strong Are They?

The character, mix, and subtleties of the competitive forces operating in a company's industry are never the same from one industry to another. The most powerful and widely used tool for systematically diagnosing the principal competitive pressures in a market and assessing the strength and importance of each is the *five forces model of competition*.¹ This model, depicted in Figure 3.3, holds that the state of competition in an industry is a composite of five competitive forces:

1. Competitive pressures stemming from the market maneuvering and strategy initiatives of *industry rivals* to enhance buyer appeal for their products, boost profitability, and win a competitive edge.
2. Competitive pressures stemming from the threat of *new entrants* into the market.
3. Competitive pressures from companies in other industries selling *substitute products*.
4. Competitive pressures stemming from the exercise of *supplier bargaining power*.
5. Competitive pressures stemming from the exercise of *buyer (or customer) bargaining power*.

Using the five forces model to determine the nature and strength of competitive pressures in a given industry involves building the picture of competition in three steps:

- *Step 1*: Identify the specific competitive pressures associated with each of the five forces.
- *Step 2*: Evaluate how strong the pressures comprising each of the five forces are (fierce, strong, moderate to normal, or weak).
- *Step 3*: Determine whether the collective strength of the five competitive forces across the industry/market is conducive to high/good industry profitability.

Figure 3.3 The Five Forces Model of Competition: A Key Analytical Tool

Source: Adapted from Michael E. Porter, “How Competitive Forces Shape Strategy,” *Harvard Business Review* 57, no. 2 (March–April 1979), pp. 137–145; Michael E. Porter, “The Five Competitive Forces that Shape Strategy,” *Harvard Business Review* 86, no. 1 (January 2008), pp. 80–86.

Competitive Pressures Created by the Rivalry among Competing Sellers

The strongest of the five competitive forces is nearly always the market maneuvering for buyer patronage that goes on among rival sellers of a product or service. In effect, *a market is a competitive battlefield* where the contest among competitors is ongoing and dynamic. Each competing company endeavors to deploy whatever means in its business arsenal it believes will attract and retain buyers, enhance its competitive strength vis-à-vis rivals, and yield good profits. The challenge is to craft a competitive strategy that, at the very least, allows a company to hold its own against rivals and that, ideally, *produces a competitive edge over many, if not all, rivals*. But when one industry competitor makes a new strategic move or boosts its competitive efforts in ways that yields good results, its rivals typically respond with offensive or defensive countermoves of their own. This pattern of action and reaction,

CORE CONCEPT

Competitive maneuvering among industry rivals is ever changing, as competing sellers initiate round after round of offensive and defensive moves, emphasizing first one mix of competitive weapons and then another in efforts to improve their market positions and profitability.

move and countermove, adjust and readjust produces a continually evolving competitive landscape where the market battle ebbs and flows, sometimes takes unpredictable twists and turns, and produces winners and losers. But the winners—the current market leaders—have no guarantees of continued leadership; their competitive success in the marketplace is no more durable than the power of their latest competitive efforts to fend off the latest competitive efforts of ambitious challengers. In every industry, the ongoing competitive jockeying of rivals leads to some companies gaining or losing momentum in the marketplace based on the success or failure of their latest competitive efforts and maneuvering in the marketplace.²

Figure 3.4 shows the competitive weapons that firms often employ in battling rivals and indicates the factors that influence the intensity of their rivalry. A brief discussion of the factors that influence the tempo of rivalry among industry competitors is in order:³

- *Rivalry intensifies when competing sellers are active in launching fresh actions to boost their market standing and business performance; conversely, rivalry is weaker when competing sellers seldom make aggressive moves to boost their sales/market shares by taking customers and sales away from rivals.* One indicator of active rivalry is lively price competition, a condition that puts pressure on industry members to drive costs out of the business and threatens the survival of high-cost companies. Another indicator of active rivalry is rapid introduction of next-generation products—when one or more rivals frequently introduce new or improved products, competitors that lack good product innovation capabilities feel considerable competitive heat to get their own new and improved products into the marketplace quickly. Other indicators of active rivalry among industry members include:
 - Whether several/many industry members are racing to differentiate their products from rivals by offering better performance features, higher quality, improved customer service, or a wider product selection.
 - How frequently some/many rivals resort to such marketing tactics as special sales promotions, heavy advertising, rebates, or low-interest-rate financing to drum up additional sales.
 - How actively some/many industry members are pursuing efforts to build stronger dealer networks or expand their presence in foreign markets or otherwise expand their distribution capabilities.
 - How hard one or more companies are striving to gain a market edge over rivals by developing new or enhanced resource strengths and competitive capabilities that rivals are hard-pressed to match.

Normally, competitive maneuvering among rival sellers is active because every competitor has a strong incentive to initiate fresh actions that hold promise for increasing buyer appeal for its products/services and boosting its profitability.

- *Rivalry is usually weaker when buyer demand is growing rapidly, and stronger when buyer demand is growing slowly or even falling.* Rapidly expanding buyer demand produces enough new business for all industry members to grow without resorting to aggressive efforts to steal sales from rivals. But in markets where growth is only 1 to 2 percent or certainly when buyer demand is shrinking, companies anxious (or sometimes desperate) to gain more business are prone to initiate aggressive price discounting, sales promotions, or other tactics to boost their sales volumes at the expense of rivals. Aggressive moves to draw customers away from rivals always heighten competitive pressures and can often ignite a fierce industrywide battle for market share.
- *Rivalry increases as it becomes less costly for buyers to switch brands and decreases as buyers' costs to switch brands become more expensive or otherwise troublesome.* The less costly it is for buyers to switch their purchases from the seller of one brand to the seller of another brand, the easier it is for sellers to steal customers away from rivals. But the higher the costs buyers incur to switch brands, the less prone they are to brand switching. Even if consumers view one or more rival brands as more attractive, they may not be inclined to switch because of the added time and inconvenience that may be involved or the psychological anguish of abandoning a long-used brand. Distributors and retailers may not switch to the brands of rival

manufacturers because they are hesitant to sever longstanding supplier relationships, incur any technical support costs or retraining expenses in making the switchover, go to the trouble of testing the quality and reliability of the rival brand, or devote resources to marketing the new brand (especially if the brand is lesser known). Consequently, unless buyers are dissatisfied with the brand they are presently purchasing, high switching costs weaken the rivalry among competing sellers.

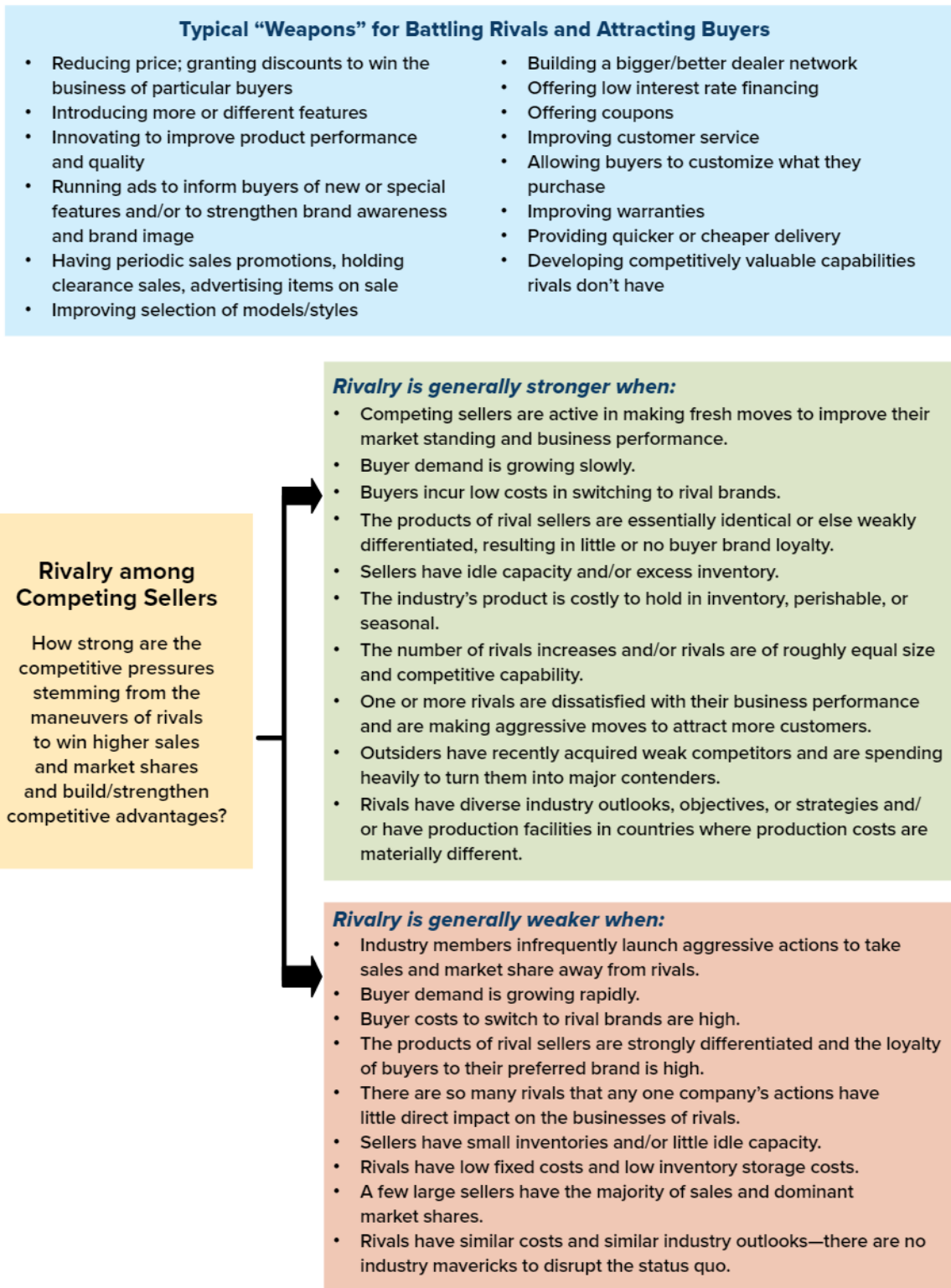
- *Rivalry increases as the products of rival sellers become less differentiated and weakens as the products of industry rivals become more strongly differentiated.* When the offerings of rivals are identical or weakly differentiated (because the brands of different sellers have identical or very comparable attributes), buyers have less reason to be brand loyal—when one brand is mostly like another, buyers can shop the market for the best deal and switch brands at will. On the other hand, strongly differentiated product offerings among rivals breed high brand loyalty—because many buyers are attached to the attributes of their preferred brand as opposed to the attributes of rival brands. Strong brand attachments make it tougher for sellers to draw customers away from rivals. Unless meaningful numbers of buyers are open to considering whatever new or different product attributes rivals are offering, the high degrees of brand loyalty that accompany strong product differentiation work against fierce rivalry among competing sellers. *The degree of product differentiation also affects switching costs.* When rivals' offerings are identical or weakly differentiated, it is usually easy and inexpensive for buyers to switch their purchases from one rival to another. Strongly differentiated products raise the probability that buyers will find it costly, inconvenient, or annoying to switch to brands with different and potentially less satisfying features.
- *Rivalry is more intense when industry members have too much inventory or significant amounts of idle production capacity, especially if the industry's product entails high storage costs or high fixed costs.* Competitive pressures among rival sellers build quickly whenever a market is oversupplied (because many rivals have excessive inventories and/or industry-wide production capacity significantly exceeds market demand for the product). Efforts on the part of sellers to rid themselves of unwanted inventories or find ways to use idle production capacity creates a “buyer's market” that not only prompts rival sellers to pursue various volume-boosting sales tactics (for example, price discounts, extra advertising, rebates, and favorable credit terms) but also empowers buyers to insist on a lower price and other favorable purchase terms or else take their business elsewhere—all of which intensifies rivalry. And if fixed costs account for a large fraction of total cost, industry members with significant amounts of idle production capacity (which raises fixed costs per unit sold and squeezes profit margins) are pressured by eroding profitability to cut prices and/or institute other volume-boosting competitive tactics—so as to spread the burdensome total fixed costs over a bigger unit sales volume, lower overall cost per unit sold, and therefore improve profit margins.
- *Rivalry tends to be more intense when a product is costly to hold in inventory, perishable, or seasonal.* This is because industry rivals have potent incentives to employ volume-boosting tactics to avoid high inventory storage costs, to rid themselves of perishable items before they spoil, and to clear out seasonal items before the end of the selling season.
- *Rivalry usually becomes more intense as competitors become more equal in size and capability, and as the number of competitors increases.* When rivals are of comparable size and competitive strength, they can usually compete on a fairly equal footing—an evenly matched contest tends to be fiercer than where one or more industry members have commanding market shares and substantially greater resources and capabilities than their much smaller rivals. A bigger number of competitors typically strengthens rivalry because the presence of more sellers raises the likelihood that fresh, creative strategic initiatives will be launched rather frequently, thereby prompting countermoves by rivals and precipitating a livelier market contest than might otherwise occur. *However*, as the number of competitors in the marketplace becomes progressively larger—so that big sales and market share gains flowing from successful strategic moves by any one company ripple out to have little discernible impact on the businesses of its many rivals—head-to-head rivalry becomes weaker. Why? Because in an industry with a large number of rivals (say, more than 20 or 30), each rival soon learns that the actions of a single rival to boost its sales and improve its market position *has minimal*

effect on its own business—the absence of an imperative to respond to the moves of each rival weakens the intensity of head-to-head battles for market share. Furthermore, rivalry *tends* to grow weaker as the number of industry members declines from 5 to 4 to 3 to just 2. This is because in a market with few rivals, each competitor soon learns that an offensive to grow its sales and market share will be viewed by rivals as a hostile move to steal their customers. *Actions that have an immediate adverse impact on rivals' sales and profits will almost certainly provoke vigorous retaliation*, potentially triggering a ferocious and costly competitive battle. Companies that have only a few strong rivals thus come to understand the merits of *restrained* efforts to wrest sales and market share from competitors as opposed to undertaking hard-hitting offensives that escalate into a price war or that force industry members to sharply increase their expenditures for advertising, sales promotions, and other inducements to secure and retain customers. Deep price discounting and a marketing arms race nearly always erode the profits of every industry participant.

- *Rivalry increases when one or more competitors become dissatisfied with their sales volumes and launch offensives to steal business away from rivals.* Firms in financial trouble or desperate for more customers often employ sales-boosting turnaround strategies that intensify rivalry. Aggressive rivals seeking to be a market leader or simply gain a bigger market share frequently initiate strategic offensives that turn competitive pressures up a notch. On occasion, rivalry intensifies because one or two industry members achieve game-changing technological breakthroughs and/or develop innovative new products that prove wildly popular, enabling them to capture significantly bigger sales volumes and market shares. In such cases, industry members that unexpectedly begin to lose many customers must scramble quickly to stay in the game; they either have to launch effective counterstrategies or become also-rans.
- *Rivalry increases when strong companies outside the industry acquire weak firms in the industry and launch aggressive, well-funded moves to transform their newly acquired competitors into strong market contenders.* A concerted effort to turn a weak rival into a formidable competitor nearly always entails launching well-financed strategic initiatives to dramatically improve the competitor's product offering, excite buyer interest, and win a much bigger market share. Such actions quickly catch the attention of all industry participants and, should such actions of the aggressor prove successful, prompts them to counter with fresh strategic offensive and defensive moves of their own.
- *Rivalry often becomes more intense—as well as more volatile and unpredictable—when competitors have diverse views about where the industry is headed and/or have sharply differing long-term directions, objectives, strategies, and competitive capabilities and/or have production facilities in different countries with different production costs.* In industries where future market conditions are murky or fast changing, differing views of rivals about where the industry is headed and the resulting differing views about how best to attract and retain customers typically sparks a spirited competitive battle for sales and market share. In globally competitive markets, attempts by cross-border rivals to gain stronger footholds in each other's domestic markets typically boost the intensity of rivalry, especially when the aggressors have lower costs or products with more attractive features. Furthermore, a diverse group of sellers often contains one or more mavericks willing to try novel, high-risk, or rule-breaking market approaches, thus generating a livelier competitive environment that can produce surprising twists and turns.

The above factors, taken as whole, determine how strong this competitive force is. Rivalry can be characterized as *cutthroat* or *brutal* when competitors engage in protracted price wars or regularly undertake other aggressive strategic moves that prove mutually destructive to profitability and inflict lower profits or even losses on most industry members. Rivalry can be considered *fierce* to *strong* when the battle for sales and market share is so vigorous that profit margins are eroded and industry profitability drops to unattractively low levels. Rivalry is *moderate* or *normal* when the maneuvering among industry members, while lively and healthy, still allows most industry members to earn acceptable profits. Rivalry is *weak* when most companies in the industry are relatively well satisfied with their sales growth and market shares, rarely undertake offensives to steal customers away from one another, and—because of weak cross-company competition—earn consistently good profits and returns on investment.

Figure 3.4 The “Weapons” That Can Be Used to Battle Rivals and the Factors Affecting the Strength of Rivalry

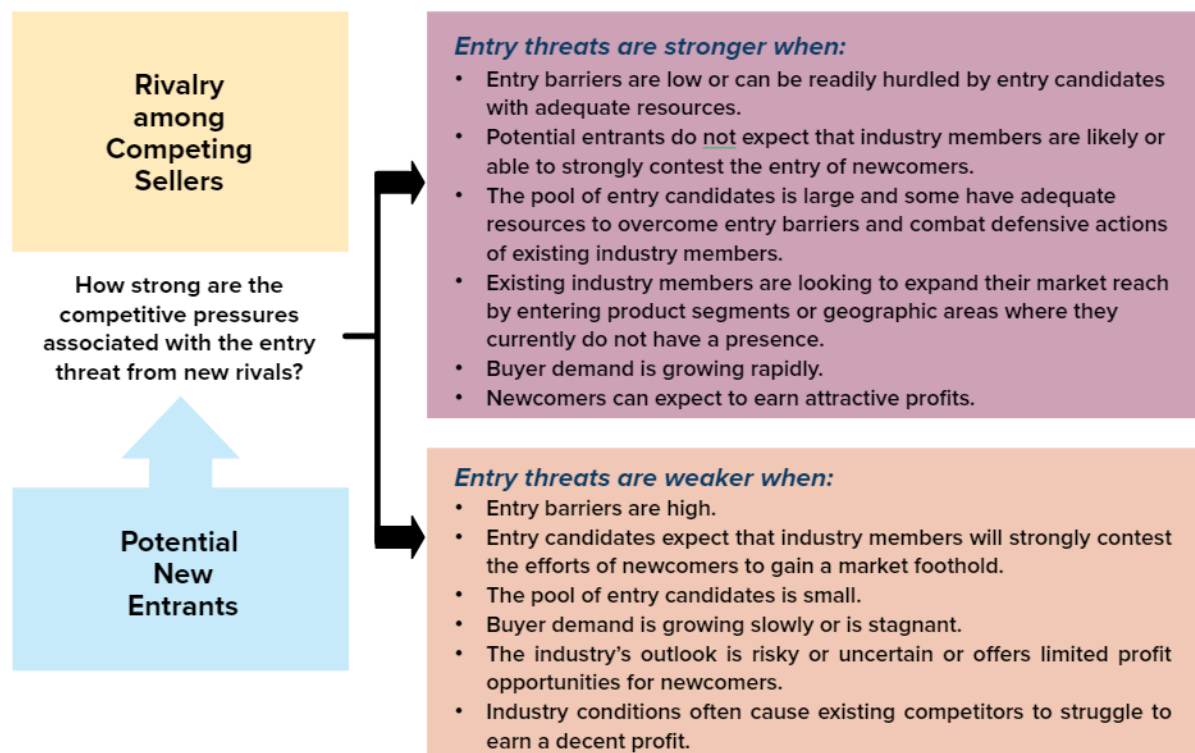


Competitive Pressures Associated with the Threat of New Entrants

A looming threat that outsiders will enter an industry intensifies the competitive pressures on existing industry members. New entry threatens the positions of current industry participants. Newcomers give buyers an additional choice of which brands to purchase, add to the industry's supply capabilities in the case of manufacturers, and expand the number of head-to-head rivals. New entrants can be expected to compete aggressively to gain a market foothold and then further expand their customer base, oftentimes taking sales and market share away from current industry members. Financially-strong newcomers with either proven competitive capabilities (or the ability to acquire them) may well evolve into formidable competitors, thus putting added competitive pressure on current industry members. To counter credible threats of entry, some/many industry members may decide to initiate defensive strategies (like announcing selective price cuts, boosting advertising, announcing intentions to accelerate new product introductions, and so on) to deter new entry and signal their intent to make it harder for new entrants to be competitively successful.

Just how serious the threat of entry is in a particular market depends on (1) whether entry barriers are high or low, (2) the expected reaction of existing industry members to the entry of newcomers, and (3) the size of the pool of likely entry candidates and the degree to which they have the resources and capabilities to become formidable competitors (see Figure 3.5).

Figure 3.5 Factors Affecting the Threat of Entry



Whether Entry Barriers Are High or Low. The strength of the threat of entry is governed to a large degree by whether potential new entrants face high or low entry barriers. High barriers reduce the threat of potential entry, whereas low barriers enable easier entry. The most widely encountered barriers that entry candidates must hurdle include:⁴

- *The cost advantages enjoyed by industry incumbents.* Existing industry members frequently have been able to reduce unit costs to levels that are hard for a newcomer to replicate. The cost advantages of industry incumbents can stem from (1) scale economies in production, distribution, or other activities, (2) the learning-based cost savings that accrue from *experience* in performing certain activities such as manufacturing or new product development or inventory management, (3) cost-savings accruing from patents or proprietary technology, (4) partnerships with the best and cheapest suppliers of raw materials and components, (5) favorable locations, and (6) low fixed costs (because they have older facilities that have been mostly depreciated). The bigger the cost advantages of industry incumbents, the riskier it becomes for outsiders to attempt entry (since they will have to accept thinner profit margins or even losses until the cost disadvantages can be overcome).
- *Strong brand preferences and high degrees of customer loyalty.* The stronger the attachments of buyers to established brands, the harder it is for a newcomer to break into the marketplace. In such cases, a new entrant must have the financial resources to spend enough on advertising and sales promotion to overcome customer loyalties and build its own clientele. Establishing brand recognition and building customer loyalty can be a slow and costly process. In addition, if it is difficult or costly for a customer to switch to a new brand, a new entrant must persuade buyers that its brand is worth the switching costs. To overcome switching-cost barriers, new entrants may have to offer buyers a discounted price or an extra margin of quality or service. All this can mean lower expected profit margins for new entrants, which increases the risk to startup companies who are dependent on sizable early profits to support their new investments.
- *High capital requirements.* The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants. The most obvious capital requirements for new entrants relate to manufacturing facilities and equipment, introductory advertising and sales promotion campaigns, working capital to finance inventories and customer credit, and sufficient cash to cover all kinds of startup costs that must be paid before sizable revenues materialize.
- *The difficulties of building a network of distributors or retailers and securing adequate space on retailers' shelves.* A potential entrant can face numerous distribution channel challenges. Wholesale distributors may be reluctant to take on a product that lacks buyer recognition. Retail dealers must be recruited and convinced to give a new brand ample display space and an adequate trial period. When existing sellers have strong, well-functioning distributor–dealer networks, a newcomer has an uphill struggle in squeezing its way into existing distribution channels. Potential entrants sometimes have to “buy” their way into wholesale or retail channels by cutting their prices to provide dealers and distributors with higher markups and profit margins, or by giving them big advertising and promotional allowances. As a consequence, a potential entrant's profits may be squeezed unless and until its product gains enough consumer acceptance that distributors and retailers are anxious to carry it.
- *Restrictive or costly regulatory policies.* Government agencies can limit or even bar entry by requiring licenses and permits. Entry into industries like cable TV, telecommunications, electric and gas utilities, radio and television broadcasting, liquor retailing, and railroads is government-controlled. In international markets, host governments commonly limit foreign entry and must approve all foreign investment applications. Government-mandated safety regulations and environmental pollution standards are entry barriers because they raise entry costs. Recently-enacted banking regulations in many countries have made entry particularly difficult for small new bank startups—complying with all the new regulations along with the various rigors of competing against existing banks requires very deep pockets.

- *Tariffs and international trade restrictions.* National governments commonly use tariffs and various kinds of burdensome trade restrictions to raise entry barriers for foreign firms and protect domestic producers from outside competition.

Whether an industry's entry barriers ought to be considered high or low depends on the resources and competencies possessed by potential entrants. Small startup enterprises may find the prevailing entry barriers insurmountable. However, current industry participants looking to expand their market reach by entering new segments or geographic areas where they currently have no market presence normally have the resources to overcome the existing entry barriers without much difficulty. Likewise, outsiders with sizable financial resources, proven competitive capabilities, and a recognized brand name may be able to hurdle an industry's entry barriers rather easily. For example, when Honda opted to enter the U.S. lawnmower market in competition against Toro, Snapper, Craftsman, John Deere, and others, it was easily able to hurdle entry barriers that would have been formidable to other newcomers because it had longstanding expertise in gasoline engines, and its well-known reputation for quality and durability in automobiles gave it instant credibility with homeowners. Honda had to spend relatively little on advertising to attract lawnmower buyers and gain a market foothold. Distributors and dealers were quite willing to handle the Honda lawnmower line, and Honda had ample capital to build a U.S. assembly plant. Similarly, Samsung's brand reputation in televisions, DVD players, and other electronics products gave it strong credibility in entering the market for smart phones—Samsung's Galaxy smartphones are now a formidable rival of Apple's iPhone.

However, it is important to understand that the barriers to entering an industry can become stronger or weaker over time. Changing industry circumstances can cause one or more entry barriers to become easier to hurdle (maybe even disappear) or harder to hurdle, thus raising or lowering the threat of entry. For example, in the pharmaceutical industry the expiration of a key patent on a widely-prescribed drug greatly lowers an important entry barrier and virtually guarantees that one or more drug makers will enter with generic offerings of their own. When companies win new patents on their technological discoveries or develop proprietary low-cost production techniques, entry barriers rise significantly. Regulatory changes can raise entry barriers when new regulations impose significant cost and compliance burdens on industry members and lower entry barriers when rules and regulations become more relaxed.

The Expected Reaction of Industry Members in Defending against New Entry A second factor affecting the threat of entry relates to the ability and willingness of industry incumbents to launch strong defensive maneuvers to maintain their positions and make it harder for a newcomer to compete successfully and profitably. Entry candidates may have second thoughts about attempting entry if they conclude that existing firms will mount well-funded campaigns to hamper (or even defeat) a newcomer's strategy to gain a market foothold big enough to compete successfully; such campaigns can include reducing prices, offering special price discounts to the very customers a newcomer is seeking to attract, stepping up advertising expenditures, running frequent sales promotions, adding attractive new product features (to match or beat the newcomer's product offering), increasing spending on R&D to speed the introduction of new and improved products, or providing additional services to customers. Strong expectations on the part of new entrants that some or many important industry incumbents will strongly contest a newcomer's entry raise a new entrant's costs and risks, perhaps by enough to dissuade some/many entry candidates from going forward. Microsoft can be counted on to fiercely defend the position that Windows enjoys in computer operating systems and that Microsoft Office has in office productivity software. The world's leading motor vehicle producers (General Motors, Ford, BMW, Volkswagen, Toyota, Daimler Benz, and others) are mounting strong defensive actions to contest the strategic intent and strategic actions of newcomer Tesla Motors to sell 500,000 battery-powered Tesla vehicles by 2021.

However, there are occasions when industry incumbents have nothing in their competitive arsenal that is formidable enough to either discourage entry or put obstacles in a newcomer's path that will defeat its strategic efforts to become a viable competitor. In the restaurant industry, for example, existing restaurants in a given geographic market have few actions they can take to discourage a new restaurant from opening or to block it from attracting enough patrons to be profitable. A fierce competitor like Nike has not prevented newcomer Under

Armour from rapidly growing its sales and market share in sports apparel. Amazon.com, despite its competitively formidable size, attractively low prices, wide selection, fast delivery, and well-regarded reputation, lacks the ability to prevent other online retailers whose merchandise lineups include items comparable to items found on Amazon's website from building a profitable customer base—rather, the number of online retailers is growing and the sales of all kinds of online retailers are exploding.

Furthermore, there are occasions when industry incumbents can be expected to refrain from taking or initiating any actions specifically aimed at contesting a newcomer's entry. In large industries, entry by small startup enterprises normally poses no immediate or direct competitive threat to industry incumbents and their entry is not likely to provoke defensive actions. For instance, a new online retailer with sales prospects of maybe \$5–\$10 million annually can reasonably expect to escape competitive retaliation from Amazon.com. The less that a newcomer's entry will adversely impact the sales and profitability of industry incumbents, the more reasonable it is for potential entrants to expect industry incumbents to ignore the entry of newcomers (in the sense of not making new competitive moves to combat the newcomer's efforts to attract customers and become profitable).

The Pool of Likely Entry Candidates and Their Resources and Competitive Capabilities. A third factor relates to the size of the pool of likely entry candidates and the competitively valuable resources at their command. As a rule, the bigger the pool of entry candidates, the stronger the threat of potential entry. This is especially true when some entry candidates have ample resources to hurdle existing entry barriers and may also have competitively valuable skills and resource strengths to become formidable contenders for market leadership. However, in many industries the strongest entry threat frequently comes not from companies outside the industry but from *existing industry members seeking to expand by entering market segments or geographic areas where they currently do not have a market presence*. Companies already well established in certain product categories or geographic areas usually possess the resources, competencies, and competitive capabilities to hurdle the barriers of entering a different market segment or new geographic area.

Industry Attractiveness Factors The fourth and final factor shaping whether the threat of entry is strong or weak is how attractive the growth and profit prospects are for new entrants. *Rapidly growing market demand and high potential profits act as magnets, growing the pool of entry candidates and motivating potential entrants to commit the resources needed to hurdle entry barriers.*⁵ When the growth opportunities and profit prospects of new entrants are sufficiently attractive, entry barriers are unlikely to be an effective entry deterrent. At most, they limit the pool of candidate entrants to enterprises with the requisite resources and competencies to compete head-to-head with incumbent firms. In contrast, when an industry's growth prospects are minimal, if its outlook is risky/uncertain, or if industry members often struggle to earn a decent profit (because the industry is plagued by intense competition or other profit-limiting conditions), the pool of potential entrants shrinks—there is seldom any good business reason for a company to enter an industry or a market segment if its prospects for good long-term profitability are poor.

CORE CONCEPT

The threat of entry is stronger when entry barriers are low, when incumbent firms are unable or unwilling to vigorously contest a newcomer's entry, when there's a sizable pool of entry candidates, and when the industry's outlook is highly attractive to outsiders.

Therefore, *a very revealing indicator of whether potential entry is a strong or weak competitive force in the marketplace is to inquire if the industry's growth and profit prospects are strongly attractive to potential entry candidates*. When the answer is no, potential entry is a weak competitive force. When the answer is yes and there are entry candidates with sufficient (maybe even competitively powerful) expertise and resources to contend with entry barriers and retaliatory moves by industry incumbents, then the looming entry threat definitely intensifies competitive pressure on current industry members.

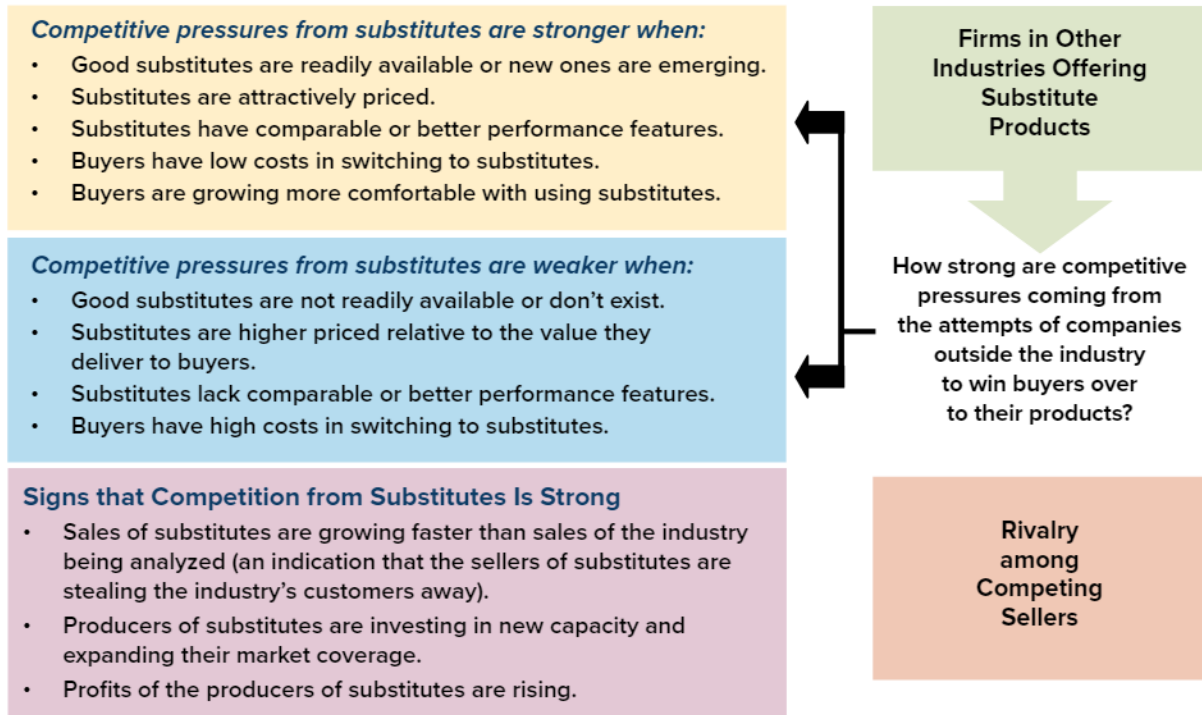
Competitive Pressures from the Sellers of Substitute Products

Companies in one industry come under competitive pressure from the actions of companies in a closely adjoining industry whenever buyers view the products of the two industries as good substitutes. For instance, the producers of wine face competitive pressures from the makers of beer and hard liquors (bourbon, vodka, tequila, rum, etc.). The producers of sugar experience competitive pressures from the producers of sugar substitutes (high-fructose corn syrup, agave syrup, and artificial sweeteners). Internet providers of news-related information have put brutal competitive pressure on the publishers of newspapers. The makers of smart phones, by building ever better cameras into their cell phones, have cut deeply into the sales of producers of handheld digital cameras—most smart phone owners now use their phone to take pictures rather than carrying a digital camera for picture-taking purposes. These examples should make it clear that the term *substitute products* (or just *substitutes*) refers specifically to products in *different* industry categories that perform the same or similar functions for consumers or meet similar consumer needs; different brands of a product/service within a given industry are *not* considered to be substitute products but rather rivals competing head-to-head within same industry category.

As depicted in Figure 3.6, three factors determine whether the competitive pressures from substitute products are strong, moderate, or weak:

1. *Whether substitutes are readily available and attractively priced.* The presence of readily available and attractively priced substitutes creates competitive pressure by placing a ceiling on the prices industry members can charge without giving customers an incentive to switch to substitutes and risking sales erosion.⁶ This price ceiling, at the same time, puts a lid on the profits that industry members can earn unless they find ways to cut costs.
2. *Whether buyers view the substitutes as comparable or better in terms of quality, performance, and other relevant attributes.* The availability of substitutes inevitably invites buyers to compare performance, features, ease of use, and other attributes besides price. The users of paper cartons constantly weigh the performance trade-offs with plastic containers and metal cans. Movie enthusiasts are increasingly weighing whether to go to movie theaters to watch newly released movies or wait till they can watch the same movies streamed to their home TV by Netflix, Amazon Prime, cable providers, and other on-demand sources. Strong competition from the providers of good-performing substitutes pressures industry participants to incorporate new features and attributes that make their product offerings more competitive and attractive to buyers.
3. *Whether the costs that buyers incur in switching to the substitutes are low or high.* Low switching costs make it easier for the sellers of attractive substitutes to lure buyers to their offering; high switching costs deter buyers from purchasing substitute products.⁷

As a rule, *the lower the price of readily available substitutes, the higher their quality and performance, and the lower the user's switching costs, the more intense the competitive pressures posed by the sellers of substitute products.* Other market indicators of the competitive strength of substitute products include (1) whether the sales of substitutes are growing faster than the sales of the industry being analyzed (a sign that the sellers of substitutes may be drawing customers away from the industry in question); (2) whether the producers of substitutes are investing in added capacity and market coverage; and (3) whether the producers of substitutes are earning progressively higher profits.

Figure 3.6 Factors Affecting Competition from Substitute Products

Competitive Pressures Stemming from Supplier Bargaining Power

Whether the suppliers of industry members represent a strong, moderate, or weak competitive force depends on how much *bargaining power* suppliers have to influence the terms and conditions of supply in their favor. Powerful or influential suppliers can be a source of competitive pressure because of their ability to charge industry members higher prices and/or make it difficult or costly for industry members to switch to other suppliers.

A number of circumstances determine the nature and strength of supplier bargaining power:⁸

- *Whether certain needed inputs are in short supply.* Suppliers of items in short supply have some degree of pricing power, whereas a surge in the available supply of particular items greatly weakens supplier pricing power and bargaining leverage.
- *Whether certain suppliers provide a differentiated input that enhances the performance or quality of the industry's product.* The more valuable a particular input is in terms of enhancing the performance or quality of industry members' products, the more bargaining leverage and pricing power such suppliers have.
- *Whether certain suppliers provide equipment or services that deliver valuable cost-saving efficiencies to industry members in operating their production processes.* Suppliers who provide cost-saving equipment or other valuable or necessary production-related services are likely to possess bargaining leverage and be in a position both to resist requests for concessions from industry members and to charge higher prices than they might otherwise be able to charge. Industry members that do not source from such suppliers may find themselves at a cost disadvantage and thus under competitive pressure to buy the cost-saving equipment or services of these suppliers (on terms that are favorable to the suppliers).

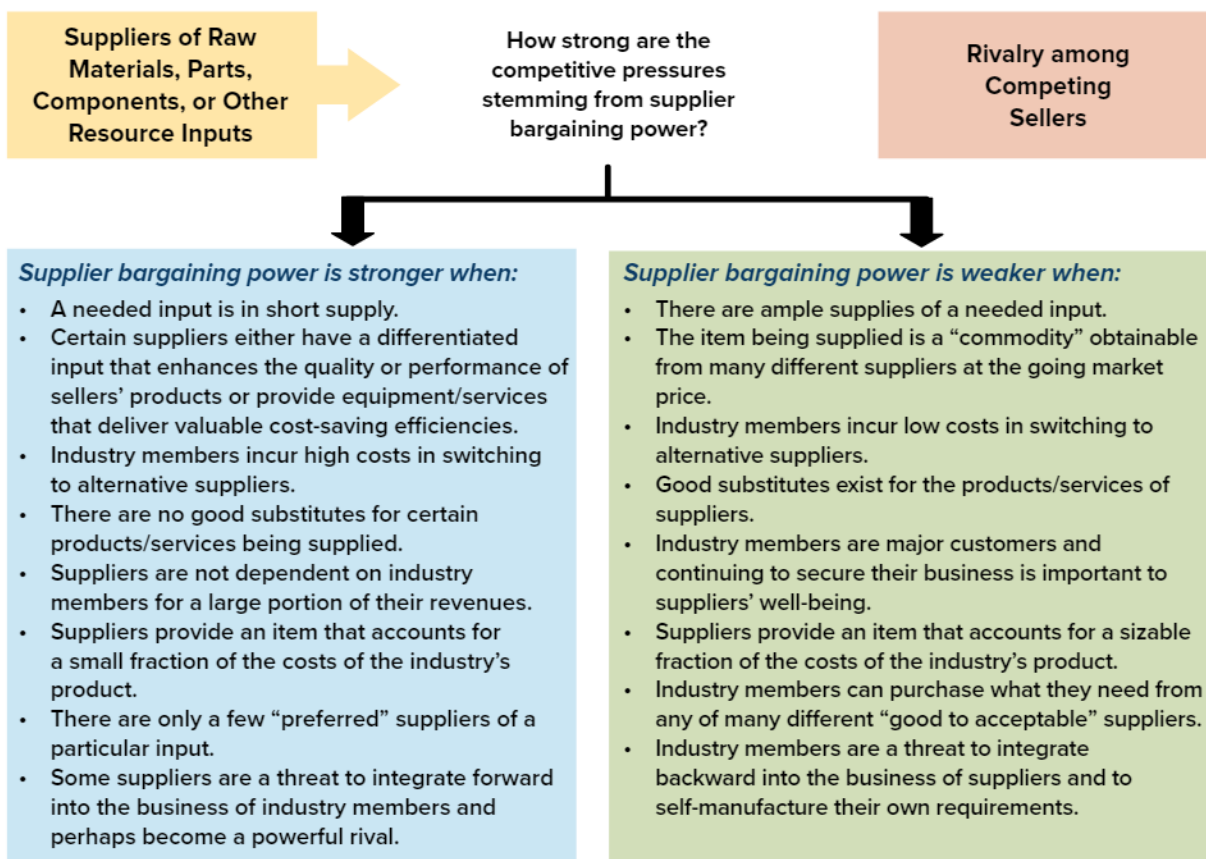
- *Whether the item being supplied is a standard item or commodity that is readily available from a host of suppliers at the going market price.* The suppliers of commodities (like copper or steel reinforcing rods or shipping cartons) are in a weak position to demand a premium price or insist on other favorable terms because industry members can readily obtain essentially the same item at the same price from any of several other suppliers eager to win their business, perhaps dividing their purchases among two or more suppliers to promote lively competition for orders. The suppliers of commodity items have market power only when supplies become so tight that industry members agree to pay more to have their orders filled and delivered on time.
- *Whether it is difficult or costly for industry members to switch their purchases from one supplier to another or to switch to attractive substitute inputs.* High switching costs convey strong bargaining power to suppliers, whereas low switching costs and ready availability of good substitute inputs weaken the bargaining power of suppliers. The lack of good substitute inputs enhances supplier bargaining power, whereas the availability of good substitute inputs weakens supplier bargaining power. Soft drink bottlers, for example, can counter the bargaining power of aluminum can suppliers by shifting or threatening to shift to greater use of plastic containers and introducing more attractive plastic container designs.
- *Whether industry members are major customers of suppliers.* As a rule, suppliers have less bargaining leverage when their sales to members of this one industry constitute a big percentage of their total sales. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers. Suppliers have a big incentive to protect and enhance the competitiveness of their major customers via reasonable prices, exceptional quality, and ongoing advances in the technology of the items supplied.
- *Whether suppliers provide an item that accounts for a sizable fraction of the costs of the industry's product.* The bigger the cost of a particular part or component, the harder it is for suppliers to boost their prices because such higher prices result in big increases in unit costs and total costs for industry members—cost increases that may adversely affect their competitiveness and long-term well-being. In such cases, suppliers must be cautious about charging prices that damage the business performance of their customers, and they can expect industry members to bargain hard in resisting suppliers' price increases. On the other hand, when suppliers' product or service accounts for a small or tiny fraction of industry members' unit costs and total costs, suppliers have added power over the price and other terms of supply; this is especially true when industry members are not major customers of these suppliers and their purchases generate only small revenues.
- *Whether only a few suppliers are regarded as the best or preferred sources of a particular item.* Highly regarded suppliers with strong demand for the items they supply generally have sufficient bargaining power to deny industry members' requests for lower prices or other concessions, and they may also have the clout to charge higher prices when they make innovative improvements in the items they supply. Nonetheless, the bargaining power of preferred suppliers can erode substantially if their profits are suffering and they need to boost sales. Moreover, the larger the number of acceptable suppliers that industry members have to purchase from, the weaker the bargaining power of any one supplier, even if they enjoy preferred status.
- *Whether industry members have sound business reasons to integrate backward and self-manufacture items they have been buying from suppliers.* The make-or-buy issue generally boils down to whether suppliers who specialize in the production of a particular part or component and who make them in volume for many different customers have the expertise and scale economies to supply as good or better components at a lower cost than industry members could achieve via self-manufacture. Frequently, it is difficult for industry members to self-manufacture parts and components more economically than they can obtain them from suppliers who specialize in making such items. For instance, most producers of outdoor power equipment (such as lawn mowers, rotary tillers, and leaf blowers) find it cheaper to source the small engines they need from outside manufacturers who specialize in small engine manufacture rather than make their own engines because the quantity of engines they need is too small to justify the investment in production facilities, master the production process, and capture scale economies.

Specialists in small engine manufacture, by supplying many kinds of engines to the whole power equipment industry, can obtain a big enough sales volume to fully realize scale economies, become proficient in all the manufacturing techniques, and keep costs low. As a rule, suppliers are safe from the threat of self-manufacture by their customers *until* the volume of parts a customer needs becomes large enough for the customer to justify backward integration into self-manufacture of the component.

- *Whether suppliers have the resources and profit incentive to integrate forward into the business of the customers they are supplying.* In instances where such is the case, suppliers have strong bargaining leverage because industry members may be willing to pay such suppliers a higher price to keep them from entering their business and potentially becoming a formidable rival.

Figure 3.7 summarizes the conditions that tend to make supplier bargaining power strong or weak.

Figure 3.7 Factors Affecting the Bargaining Power of Suppliers



Competitive Pressures Stemming from Buyer Bargaining Power

Whether buyers are able to exert strong competitive pressures on industry members depends on (1) the degree to which some or many buyers have sufficient bargaining power to obtain price concessions and other favorable purchase terms and (2) the extent to which buyers are price-sensitive. Buyers with strong bargaining power are a source of competitive pressure because they are in position to push hard for price concessions, better payment terms, additional features and services, and/or other special treatment that typically squeeze industry members' profit margins. High levels of buyer price sensitivity are a source of competitive pressure because of large numbers of price sensitive buyers place limits on seller ability to raise prices without suffering declining unit sales and revenue erosion.

The Factors Affecting Whether Buyers Have Strong or Weak Bargaining Power As with suppliers, the leverage that buyers have in negotiating favorable terms can range from weak to strong. Individual consumers seldom have much bargaining power in negotiating price concessions or other favorable terms with sellers; the primary exceptions involve situations in which price haggling is customary, such as the purchase of new and used motor vehicles, homes, and other big-ticket items like luxury watches, jewelry, works of art, and pleasure boats. For most consumer products and services, individual buyers have negligible bargaining leverage because they purchase in small quantities and often irregularly—their option is to pay a seller's posted price or take their business elsewhere. Small businesses usually have weak bargaining power because of the small-size orders they place with sellers. Many relatively small wholesalers and retailers that have very little buyer bargaining power acting on their own join buying groups to pool their purchasing power and approach manufacturers for better terms than could be gotten individually.

Understandably, large retail chains like Walmart, Best Buy, Staples, The Home Depot, and Kroger typically have considerable bargaining power in purchasing products from manufacturers not only because they buy in large quantities but also because of manufacturers' need for broad retail exposure and the most appealing shelf locations. Retailers may stock two or three competing brands of a product but rarely all competing brands, so competition among rival manufacturers for visibility on the shelves of popular multistore retailers gives such retailers significant bargaining strength. Major supermarket chains like Kroger, Albertson's (also the owner of Safeway and eleven other supermarket brands), and Publix have sufficient bargaining power to demand promotional allowances and lump-sum payments (called slotting fees) from food products manufacturers in return for stocking certain brands or putting them in the best shelf locations. Motor vehicle manufacturers have strong bargaining power in negotiating to buy original equipment tires from Goodyear, Michelin, Bridgestone/Firestone, Continental, and Pirelli partly because they buy in large quantities and partly because tire makers believe they gain an advantage in supplying replacement tires to vehicle owners if their tire brand is original equipment on the vehicle. On occasions, *"prestige" buyers have a degree of clout in negotiating with sellers because a seller's reputation is enhanced by having prestige buyers on its customer list.*

Buyers' bargaining power is stronger when they are few in number and purchase in large volumes. The larger buyers' purchases, the more important their business is to sellers and the more likely that sellers will grant them concessions or special treatment.

Even if buyers do not purchase in large quantities or provide sellers better market exposure or an enhanced reputation, their bargaining strength increases in the following circumstances:⁹

- *When buyer demand is weak in relation to the available supply and industry members are eager to sell more units.* Weak or declining demand and the resulting excess supply create a "buyers' market" where bargain-hunting buyers have leverage in pressing industry members for better deals and special treatment. Conversely, strong or rapidly growing market demand creates a "sellers' market" characterized by tight supplies or shortages—conditions that put buyers in a weak position to wring concessions from industry members.
- *When industry members' products are standardized "commodities" or else weakly differentiated.* In such instances, buyer loyalty to any one brand is low, and buyers tend to shop for the best price, which usually spurs price competition among industry members. However, buyer bargaining power declines as the products/services of industry members become *strongly differentiated*—the bigger the differences among the features, performance, and quality of rival brands, the more buyers come to prefer the brand most suitable to their preferences and pocketbook. Strong buyer attachment to a favorite brand diminishes buyer bargaining power, particularly when an industry member knows full well that buyers recognize the superiority of its product offering.
- *When buyers have low costs in switching to competing brands or substitutes.* Buyers who can readily switch brands or source from several competing sellers have more negotiating leverage than buyers who have high switching costs or strong loyalty to a particular brand.

- *When the number of buyers is small or retaining a particular buyer's business is important to a seller.* The smaller the number of buyers, the harder it is for industry members to find alternative buyers when a customer is lost to a rival. The prospect of losing a customer not easily replaced often makes an industry member willing to grant concessions of one kind or another to retain the customer's business.
- *When buyers are well informed and have compared the product offerings of industry members regarding prices, product features, quality, buyer reviews, and other pertinent factors.* The more information buyers have about the comparative product offerings of industry members, the better bargaining position they are in. The mushrooming availability of product information at Internet websites enables businesses and individuals to compare different products and locate industry members with the best deals. Armed with this information, bargain-hunting businesses can contact one or more low-priced industry members and try to wrangle an even better deal. Similarly, individuals can use information gleaned from the Internet to bargain with local retailers, a technique that works well when it comes to buying new and used motor vehicles and other big-ticket items.
- *When buyers pose a credible threat of integrating backward into the business of sellers.* Retailers gain bargaining power in negotiating with the makers of popular name brand products by stocking and promoting their own private-label brands alongside manufacturers' brands. Beer producers like Anheuser Busch InBev SA/NV (whose brands include Budweiser, Coors, Miller, Molson, and Heineken) have integrated backward into metal can manufacturing to gain bargaining power in obtaining the balance of their beer containers from can and bottle manufacturers. But such buyer bargaining power evaporates when there is no credible threat of buyers integrating backward into the business of sellers/industry members.
- *When buyers have discretion to delay their purchases or perhaps not make a purchase at all.* Consumers often have the option to delay purchases of durable goods (cars, major appliances, a home addition) or discretionary goods (hot tubs, home entertainment centers) if they are unhappy with the prices offered. If college students believe the prices of new textbooks are too high, they can purchase used textbooks or rent them or share them with friends. Business buyers may be able to defer spending for new equipment, software upgrades, or maintenance services. Such options put pressure on industry members to grant concessions to prospective buyers to keep their sales numbers from dropping off.

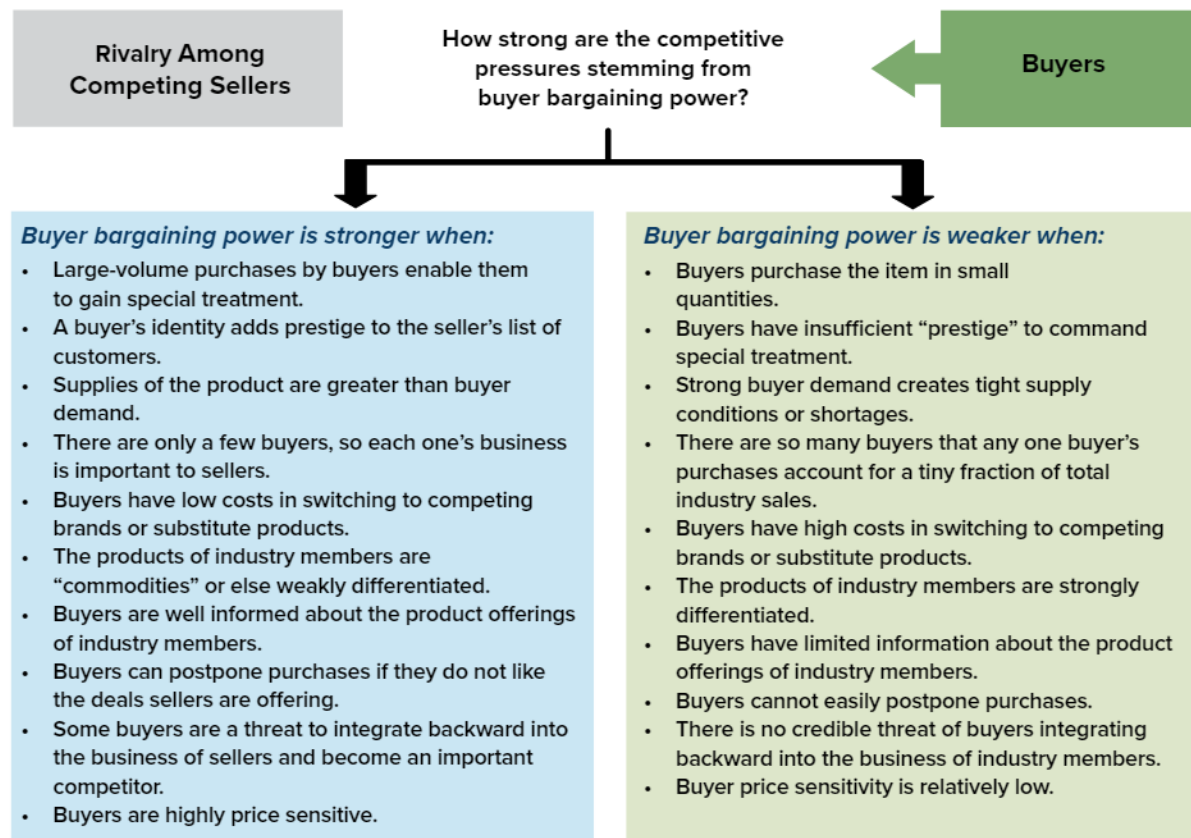
Strong Buyer Price Sensitivity Creates Competitive Pressures Low-income and budget-constrained consumers are almost always price sensitive; bargain-hunting consumers are highly price sensitive by nature. Most consumers grow more price sensitive as the price tag of an item becomes a bigger fraction of their spending budget. Business buyers besieged by weak sales, intense competition, and other factors squeezing their profit margins are price sensitive. Price sensitivity also grows among all businesses as the cost of an item becomes a bigger fraction of their cost structure. Rising prices of frequently purchased items heightens the price sensitivity of all types of buyers.

Widespread or rapidly growing price sensitivity among buyers creates competitive pressures on industry members in two ways: (1) it limits their ability to charge prices that buyers perceive as "too high" and (2) it constrains industry member ability to raise prices. Price-related competitive pressures on industry members escalate further if buyer concerns about overly high prices spark a falloff in demand for the industry's product/service—buyers having a hard time making ends meet may decide to reduce or defer their purchases or switch to cheaper-priced substitutes. Business customers suffering weak sales or profitability problems may communicate their unhappiness over prices directly to industry members and announce their intention to curtail purchases or switch to lower-priced substitutes.

Collective action on the part of growing numbers of individuals, households, and businesses to curtail purchases escalates competitive pressure on industry members, sometimes exponentially, and can become a potent competitive force. Fear of a potential sales decline or the harsh winds of an actual sales decline can prompt industry members to act on their own to trim prices or grant other more favorable purchase terms to buyers. In such circumstances, buyer bargaining power increases, and industry members anxious to grow their sales volumes become more willing to bargain with buyers over price and other terms of sale.

Figure 3.8 highlights the circumstances causing buyer bargaining power to be strong or weak.

Figure 3.8 Factors Affecting the Bargaining Power of Buyers



Is the Collective Strength of the Five Competitive Forces Conducive to Good Profitability?

Assessing whether each of the five competitive forces gives rise to strong, moderate, or weak competitive pressures sets the stage for evaluating whether *the collective strength* of the five forces is conducive to good profitability. Can companies in this industry reasonably expect to earn decent profits in light of the prevailing competitive forces? Are competitive forces sufficiently powerful to undermine industry profitability? Or, is the state of competition in the industry weaker than "normal," thus opening opportunities for industry members to earn very attractive profits?

As a rule, the stronger the collective impact of the five competitive forces, the lower the combined profitability of industry participants. The most extreme case of a "competitively unattractive" industry occurs when all five forces are producing strong competitive pressures: rivalry among sellers is vigorous, low entry barriers allow new rivals to gain a market foothold, competition from substitutes is intense, and both suppliers and buyers are able to exercise considerable bargaining leverage. Fierce to strong competitive pressures coming from all five directions nearly always drive industry profitability to unacceptably low levels, frequently producing losses for many industry members and forcing some out of business. But an industry can be competitively unattractive without all five competitive forces being strong. Intense competitive pressures from just two or three (maybe even just one) of the five forces may suffice to

The stronger the forces of competition, the harder it becomes for industry members to earn attractive profits.

destroy the conditions for good profitability, and prompt struggling companies to exit the business. Especially intense competitive conditions seem to be the norm in tire manufacturing, apparel, and commercial airlines—all three industries have long been characterized by historically thin profit margins.

In contrast, when the collective impact of the five competitive forces is moderate to weak, an industry is competitively attractive in the sense that industry members can reasonably expect to earn good profits and a nice return on investment. The ideal competitive environment for earning superior profits is one in which both suppliers and customers are in weak bargaining positions, there are no good substitutes, high barriers block further entry, and rivalry among present sellers generates only moderate competitive pressures. Weak competition is the best of all possible worlds for also-ran companies because even they can usually eke out a decent profit—if a company can't make a decent profit when competition is weak, then its business outlook is indeed grim.

In most industries, the collective strength of the five competitive forces is somewhere near the middle of the two extremes of intense and weak, typically ranging from slightly stronger than normal to slightly weaker than normal and typically allowing well-managed companies with sound strategies to earn attractive profits.

Matching Company Strategy to Competitive Conditions Working through the five forces model step by step not only aids strategy-makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better match company strategy to the specific competitive character of the marketplace. Effectively matching a company's strategy to prevailing competitive conditions has two aspects:

A company's strategy is increasingly effective the more it provides some insulation from competitive pressures and shifts the competitive battle in the company's favor.

1. Pursuing avenues that shield the firm from as many of the different competitive pressures as possible.
2. Initiating actions calculated to produce sustainable competitive advantage, thereby shifting competition in the company's favor, putting added competitive pressure on rivals, and perhaps even defining the business model for the industry.

But making headway on these two fronts first requires identifying competitive pressures, gauging the relative strength of each of the five competitive forces, and gaining a deep enough understanding of the state of competition in the industry to know which strategy buttons to push.

Question 2: What Factors Are Driving Industry Change and What Impact Will They Have?

While it is critical to understand the nature, intensity, and fluidity of competitive forces in an industry, there are also other types of factors that gradually or speedily alter industry conditions in ways important enough to require a strategic response from participating firms. The popular hypothesis that industries go through a life cycle of takeoff, rapid growth, early maturity and slowing growth, market saturation, and stagnation or decline is but one aspect of industry change—many other new developments and emerging trends cause industry change besides an industry's so-called normal progression through the life cycle.¹⁰

The Concept of Driving Forces

Industry environments are dynamic and, in most all cases, contain forces that are enticing or pressuring certain industry participants (competitors, customers, suppliers) to alter their actions in important ways.¹¹ The most powerful of the change agents are called driving forces because they have the biggest influences in reshaping the industry landscape and altering competitive conditions. Some driving forces originate in the outer ring of the company's macro-environment (see Figure 3.2), but most originate in the company's more immediate industry and competitive environment.

Driving-forces analysis has three steps: (1) identifying what the driving forces are, (2) assessing whether the drivers of change are, on the whole, acting to make the industry more or less attractive, and (3) determining what strategy changes are needed to prepare for the impacts of the driving forces. All three steps merit further discussion.

CORE CONCEPT

Industry conditions change because important forces are *driving* industry participants (competitors, customers, or suppliers) to alter their actions. The **driving forces** in an industry are the *major underlying causes* of changing industry and competitive conditions—they have the biggest influence on how the industry landscape will be altered. Some driving forces originate in the outer ring of the macro-environment, and some originate in the inner ring.

Identifying an Industry's Driving Forces

Many developments can affect an industry powerfully enough to qualify as driving forces. Some drivers of change are unique and specific to a particular industry situation, but most drivers of industry and competitive change fall into one of the following categories:¹²

- *Changes in an industry's long-term growth rate.* Faster industry growth triggers a race among established firms and newcomers to capture the new sales opportunities; ambitious companies with trailing market shares may see the upturn in buyer demand as a golden opportunity to launch offensive strategies to broaden their customer base and move up several notches in the industry standings. Slower industry growth nearly always intensifies rivalry as firms anxious to grow rapidly pursue ways to take sales and market share away from rivals. Other industry members may respond to a growth slowdown by merging with or acquiring other industry members. Should industry sales stagnate or enter into long-term decline, some competitively weak and/or growth-oriented companies may opt to exit the industry by selling their operations to those industry members who elect to stick it out. When demand for an industry's product continues to shrink, the remaining industry members will likely be forced to close inefficient plants and retrench to a smaller production base. Hence, whether an industry's growth rate turns up or down, starts to stagnate, or becomes negative, the usual outcome is a much-changed competitive landscape.
- *Increasing globalization.* Competition begins to shift from primarily a regional or national focus to an international or global focus when industry members begin seeking out customers in foreign markets or when production activities begin to migrate to countries where costs are lowest. Globalization of competition really starts to take hold when one or more ambitious companies precipitate a race for worldwide market leadership by launching initiatives to expand into more and more country markets. Globalization can also be precipitated by the blossoming of consumer demand in more and more countries and by government actions in certain countries to reduce trade barriers or open up once-closed markets to foreign competitors, as is occurring in many parts of Europe, Latin America, and Asia. Significant differences in labor costs among countries give manufacturers a strong incentive to locate plants for labor-intensive products in low-wage countries and use these plants to supply market demand across the world. Wages in China, India, Vietnam, Mexico, and Brazil, for example, are much lower than those in the United States, Germany, and Japan. The forces of globalization are sometimes such a strong driver that companies find it highly advantageous, if not necessary, to spread their operating reach into more and more country markets. Globalization is very much a driver of industry change in industries like motor vehicles, steel, petroleum, electronics, mobile phones, video games, public accounting, commercial aircraft, and electric power generation equipment.

- *Emerging new Internet capabilities and applications.* Mushrooming use of high-speed Internet service and Voice-over-Internet-Protocol (VoIP) technology, growing acceptance of online shopping, and the exploding popularity of Internet applications (“apps”) have been major drivers of change in industry after industry. The ability of companies to reach consumers via the Internet increases their geographic reach, brings more sellers into head-to-head competition, and often escalates rivalry by pitting pure online sellers against combination brick-and-click sellers and against pure brick-and-mortar sellers. The Internet gives buyers an unprecedented ability to research competitors’ product offerings and shop the market for the best value. Widespread use of e-mail has forever eroded the business of providing fax services and the first-class mail delivery revenues of governmental postal services worldwide. Videoconferencing via the Internet erodes the demand for business travel. Online course offerings are profoundly affecting higher education. The “Internet of things” will feature faster speeds, dazzling applications, and billions of connected gadgets performing an array of functions, thus driving further industry and competitive changes. But Internet-related impacts vary from industry to industry. The challenges here are to assess precisely how emerging Internet developments are altering a particular industry’s landscape and to factor these impacts into the strategy-making equation.
- *Changes in who buys the product and how buyers use it.* Shifts in buyer demographics and the ways products are used can greatly alter industry and competitive conditions. Longer life expectancies are driving demand growth in health care, prescription drugs, and assisted living residences. Growing percentages of relatively well-to-do retirees are driving demand growth in cosmetic surgery, vacation travel, and assisted living residences. New features of next-generation smart phones, along with an ever-growing array of apps, continue to transform the user experience, attract more types of buyers, shorten the life cycles of cell phone models, and enable a more-connected world. The growing popularity of streaming video has impacted the businesses of broadband providers, wireless phone carriers, television broadcasters, and such content providers as Netflix and Amazon’s Prime Video.
- *Product innovation.* Competition in an industry is always affected by rivals racing to be first to introduce some new product or product enhancement, one after another. An ongoing stream of product innovations tends to alter the pattern of competition in an industry by attracting more first-time buyers, rejuvenating industry growth, and/or creating wider or narrower product differentiation among rival sellers. Product innovation has been a key driving force in such industries as lightbulbs, golf clubs, performance fabrics for sports apparel, good-for-you food products, and self-driving motor vehicles.
- *Technological change and manufacturing process innovation.* Advances in technology and new manufacturing processes can cause disruptive change in an industry by making it possible to produce dramatically new and better products at lower cost and sometimes opening up whole new industry frontiers. Rapidly advancing self-driving technology is disrupting the motor vehicle industry, enabling such companies as Google and chip-maker Nvidia to enter the industry. Stem cell research holds promise for finding ways to cure or treat an array of diseases. Advancing robotics technology is a big driver of manufacturing process innovation.
- *Marketing innovation.* When firms are successful in introducing *new ways* to market their products, they can spark a burst of buyer interest, widen industry demand, increase product differentiation, and lower unit costs—any or all of which can alter the competitive positions of rival firms and force strategy revisions. Growing popularity of online shopping is shaking up the retailing industry, depressing buyer traffic at shopping malls and altering the mix of sales through various distribution channels. Increasing numbers of music artists are marketing their recordings at their own websites rather than entering into contracts with recording studios. The growing propensity of advertisers to place a bigger percentage of their ads on social media sites like Facebook and Twitter is shaking up the advertising industry.
- *Entry or exit of major firms.* The entry of one or more foreign companies into a geographic market once dominated by domestic firms nearly always shakes up competitive conditions. Likewise, when an established domestic firm from another industry attempts entry either by acquisition or by launching its own startup venture, it usually applies its skills and resources in some innovative fashion that pushes competition in new directions. Entry by a major firm thus often produces a new ball game, not only with new key players

but also with new rules for competing. Similarly, a major firm's exit changes the competitive structure by reducing the number of market leaders (perhaps increasing the dominance of the leaders who remain) and causing a rush to capture the exiting firm's customers.

- *Diffusion of technical know-how across more companies and more countries.* As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, the competitive advantage held by firms originally possessing this know-how erodes. Knowledge diffusion occurs through scientific journals, trade publications, onsite plant tours, word of mouth among suppliers and customers, worker migration, and Internet sources. In recent years, *rapid technology transfer across national boundaries has been a prime factor in causing industries to become more globally competitive.*
- *Changes in cost and efficiency.* Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. Lower production costs and longer-life products have allowed the makers of super-efficient fluorescent-based spiral lightbulbs and LED bulbs to cut deeply into the sales of incandescent lightbulbs. Lower-cost e-books are cutting into sales of costlier hardcover books as increasing numbers of consumers have laptops, iPads, Kindles, and other brands of tablets.
- *Growing buyer preferences for differentiated products instead of a commodity product (or for a more standardized product instead of strongly differentiated products).* When buyer tastes and preferences start to diverge, sellers can win a loyal following by introducing products that stand apart from those of rival brands. In recent years, beer drinkers have grown less loyal to traditional brands; many are shifting to “boutique” beers with distinctive tastes. Leading beer manufacturers have responded by introducing new distinctive-tasting brands of their own. The consequently larger number of brands and varieties has made competition livelier. When a shift from standardized to differentiated products occurs, the driver of change is the contest among rivals to cleverly out-differentiate one another.

Sometimes, however, buyers decide that a standardized budget-priced product suits their requirements as well as or better than a premium-priced product with lots of snappy features and personalized services. Pronounced shifts toward greater product standardization (as in grocery items where the difference between brand-name products and private-label products is frequently miniscule) usually spawn lively price competition and force rival sellers to drive down their costs to maintain profitability. The lesson here is that competition is driven partly by whether the market forces in motion are acting to increase or decrease product differentiation.

- *Reductions in uncertainty and business risk.* Many companies are hesitant to enter industries with uncertain futures or high levels of business risk, and firms already in these industries may be cautious about making aggressive capital investments to expand—often because it is unclear how much time and money it will take to overcome various technological hurdles and achieve acceptable production costs (as is the case in the solar power industry). Likewise, firms entering foreign markets where demand is just emerging or where political conditions are volatile may be cautious and limit their downside exposure by using less risky strategies. Over time, however, diminishing risk levels and uncertainty tend to stimulate new entry and capital investments by growth-minded companies seeking new opportunities, thus dramatically altering industry and competitive conditions.
- *Regulatory influences and government policy changes.* Government regulatory actions can often mandate significant changes in industry practices and strategic approaches—as has occurred in the world's banking industry over the past ten years. In the United States, a deluge of much stricter banking regulations during the Obama Administration profoundly altered the operations of banks of all sizes; but starting in 2017 there have been sweeping efforts during the Trump Administration to undo or modify the thousands of banking rules and regulatory requirements imposed during 2008–2016. New rules and regulations pertaining to government-sponsored and/or government-mandated health insurance programs are potent driving forces in the health care industry. It is common practice across the world for governments to grant subsidies or tax breaks to industries whose products they deem worthy of governmental support (like electric vehicles

and solar energy) and to impose higher taxes or burdensome regulation on those industries whose products they deem harmful (like cigarettes) or whose operations involve heavy use of fossil fuels. In industries with big volumes of international trade, governments can drive competitive changes by opening their domestic markets to desirable foreign imports or by erecting tariff barriers and other trade restrictions to protect domestic companies from foreign competitors. Clearly, the Trump Administration has used the threat/imposition of high tariffs on various imported products as a bargaining tactic to incentivize governments across the world to eliminate existing trade inequities, lower the barriers to imports from the United States, and establish “fair trade” arrangements affecting many industries and product categories in many countries.

- *Changing societal concerns, attitudes, and lifestyles.* Emerging social issues, as well as changing attitudes and lifestyles, can be powerful instigators of industry change. Growing public concern about climate change has emerged as a major driver of change in the energy industry. The trend to more casual business dress has dramatically affected the apparel industry. Greater affinity for having household pets has driven growth across the whole pet industry. Shifting societal concerns, attitudes, and lifestyles alter the pattern of competition, usually favoring those players that respond quickly and creatively with products targeted to the new trends and conditions.

That there are so many different *potential driving forces* explains why a full understanding of all types of change drivers is a fundamental part of industry analysis. However, labeling every change or trend as a driving force must be resisted; no more than three or four are likely to be true driving forces powerful enough to reshape an industry's landscape in significant ways. The true analytical task is to evaluate the forces of change carefully enough to separate the major ones from the minor ones.

Assessing the Impact of the Driving Forces

Just identifying the driving forces is not sufficient, however. The second, and more important, step in driving-forces analysis is to determine whether the prevailing driving forces are, on the whole, acting to make the industry environment more or less attractive. Answers to three questions are needed:

1. Are the driving forces, on balance, acting to cause demand for the industry's product to increase or decrease?
2. Is the collective impact of the driving forces making competition more or less intense?
3. Will the combined impacts of the driving forces lead to higher or lower industry profitability?

The most important part of driving-forces analysis is to determine whether the collective impact of the driving forces will be to increase or decrease market demand, make competition more or less intense, and lead to higher or lower industry profitability.

Getting a handle on the collective impact of the driving forces usually requires looking at the likely effects of each force separately since the driving forces may not all be pushing change in the same direction. For example, two driving forces may be spurring demand for the industry's product, while one driving force may be curtailing demand. Whether the net effect on industry demand is up or down hinges on which driving forces are the more powerful.

Adjusting Strategy to Prepare for the Impacts of Driving Forces

The third step of driving-forces analysis—where the real payoff for strategy making comes—is for managers to draw some conclusions about *what strategy adjustments will be needed to deal with the impacts of the driving forces*. But taking the “right” actions to prepare for the industry and competitive changes being wrought by the driving forces first requires accurate diagnosis of the forces driving industry change and the impacts these forces will have on both the industry environment and the company’s business. To the extent that managers are unclear about the drivers of industry change and their impacts, or if their views are off-base, the chances of making astute and timely strategy adjustments are slim. So, driving-forces analysis is not something to take lightly; it is a valuable tool for managers to use in thinking strategically about where the industry is headed and preparing for the changes ahead.

The real payoff of driving-forces analysis is to help managers understand what strategy changes are needed to prepare for the impacts of the driving forces.

Question 3: What Market Positions Do Rivals Occupy—Who Is Strongly Positioned and Who Is Not?

Some industry rivals occupy stronger (or at least distinguishably different) market positions than others, having opted to incorporate product features that appeal to different types of buyers, or charge widely differing prices for products with widely differing quality and/or performance, or emphasize different distribution channels, or compete in different geographic areas, and so on. Understanding which companies are strongly positioned and which are weakly positioned is an integral part of analyzing an industry’s competitive structure. The best technique for revealing the market positions of industry competitors is strategic group mapping.¹³

CORE CONCEPT

Strategic group mapping is a technique for displaying the different market positions that rival firms occupy in the industry.

Using Strategic Group Maps to Assess the Market Positions of Key Competitors

A strategic group consists of those industry members with similar competitive approaches and positions in the overall market.¹⁴ Companies in the same strategic group can resemble one another in any of several ways: they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same distribution channels, use essentially the same product attributes to appeal to similar types of buyers, depend on identical technological approaches, compete in much the same geographic areas, or offer buyers similar services and technical assistance.¹⁵ An industry contains only one strategic group when all sellers compete in much the same market space, employing much the same strategies to appeal to much the same types of buyers. At the other extreme, an industry may contain as many strategic groups as there are competitors when each rival pursues a distinctly different competitive approach, strives to attract different types of buyers with distinctly different product offerings, and thus occupies a distinctly different market position. The number of strategic groups in an industry and their respective market positions can be displayed on a strategic group map.

CORE CONCEPT

A strategic group is a cluster of industry rivals that employ similar competitive approaches, have product offerings that appeal to similar types of buyers, and thus occupy similar market positions.

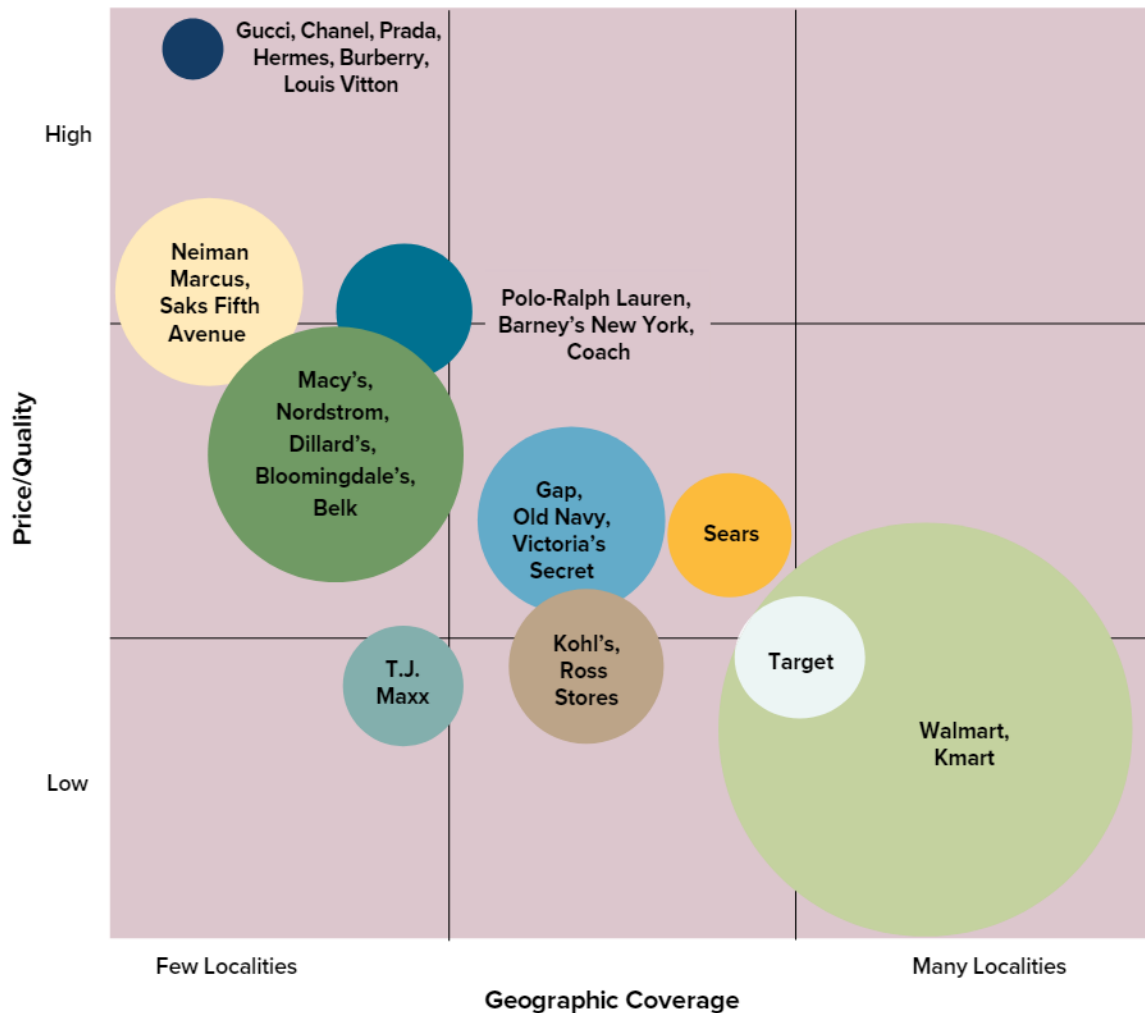
The procedure for drawing a *strategic group map* is straightforward:

- Identify the competitive characteristics that differentiate firms in the industry. Typical variables are price/quality range (high, medium, low), geographic coverage (local, regional, national, global), product-line breadth (wide, narrow), degree of service offered (no-frills, limited, full), use of distribution channels (one, some, all), and degree of vertical integration (none, partial, full).
- Plot the firms on a two-variable map using pairs of these differentiating characteristics.
- Assign firms that are located close together on the two-dimensional map to the same strategic group.
- Draw circles around each strategic group, making the circles proportional to the size of the group's share of total industry sales revenues.

This produces a two-dimensional diagram like the one shown in Figure 3.9.

Several guidelines need to be observed in mapping the positions of strategic groups in the industry's overall market space.¹⁶ First, the two variables selected as axes for the map should *not* be highly correlated. If they are, the circles on the map will fall along a diagonal and reveal nothing more about the relative positions of competitors than would be revealed by comparing the rivals on just one of the variables. For instance, if companies with broad product lines use multiple distribution channels while companies with narrow lines use a single distribution channel, then looking at broad versus narrow product lines reveals just as much about who is positioned where as does looking at single versus multiple distribution channels—rendering one of the variables redundant. Second, *the two variables chosen as axes should be ones where there are big differences in the competitive characteristics and positioning among the rivals*—when rivals differ on both variables, the locations of the rivals will be scattered, thus showing how they are positioned differently. Third, the variables used as axes do not have to be quantitative or continuous; rather they can be defined as distinct conditions like use of only one distribution channel (Internet sales at the company's website), use of two distribution channels (company-owned retail stores and Internet sales), use of three distribution channels (independent wholesale distributors, big-box discount retailers, and Internet sales at the company's website), and use of multiple distribution channels (four or more). Fourth, drawing the sizes of the circles on the map proportional to the combined sales of the firms in each strategic group allows the map to reflect the relative market shares that each strategic group commands. Fifth, if three or more variables are good candidates for being chosen as axes for the map, it is wise to draw two or more maps to give different exposures to the competitive positioning relationships present in the industry's structure—there is not necessarily any one best map for portraying how competing firms are positioned.

**Figure 3.9 Comparative Market Positions of Selected Retail Chains:
An Example of a Strategic Group Map**



Note: Circles are drawn roughly proportional to the total revenues of the retailers shown in each strategic group.

What Can Be Learned from Strategic Group Maps?

Strategic group maps are revealing in several respects. The most important information revealed is which industry members are close rivals and which are distant rivals. Firms in the same strategic group are the closest rivals; the next closest rivals are in the immediately adjacent groups. Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, Walmart's clientele, merchandise selection, and pricing points are much too different to justify calling them close competitors of Neiman Marcus, Saks Fifth Avenue, or Gucci.

Strategic group maps reveal which companies are close competitors and which are distant competitors.

The second thing to be gleaned from strategic group mapping is that *not all positions on the map are equally attractive*.¹⁷ Two reasons account for why some positions can be more attractive than others:¹⁸

1. *Prevailing competitive pressures and industry driving forces favor some strategic groups and hurt others.* Discerning which strategic groups are advantaged and disadvantaged requires scrutinizing the map in light of what has also been learned from the prior analysis of competitive forces and driving forces. Quite often the strength of competition varies from group to group—there's little reason to believe that all firms in an industry feel the same degrees of competitive pressure, since their strategies and market positions may well differ in important respects. For instance, the competitive battle between Walmart and Target is of a different character and intensity than the rivalry among Gucci, Chanel, Fendi, and other high-end fashion retailers. Likewise, industry driving forces can boost the business outlook for some strategic groups and adversely impact the business prospects of others. Firms in strategic groups that are being adversely impacted by intense competitive pressures or driving forces may try to shift to a more favorably situated group if they can hurdle the barriers to enter the target strategic group. If certain firms are known to be trying to change their competitive positions on the map, then attaching arrows to the circles showing the targeted direction helps clarify the picture of competitive maneuvering among rivals.
2. *Profit prospects vary from strategic group to strategic group.* The profit prospects of firms in different strategic groups can vary from good to ho-hum to poor because of differing growth rates in buyer demand for the market segments each group serves, differing degrees of competitive rivalry within strategic groups (due perhaps to variations in entry barriers, product/brand differentiation, and customer loyalty), differing degrees of exposure to competition from substitute products outside the industry, differing degrees of supplier or buyer bargaining power from group to group, and differing impacts from the industry's driving forces.

CORE CONCEPT

Some strategic groups are more favorably positioned than others because they confront weaker competitive forces and/or because they stand to be favorably impacted by the industry's driving forces.

Thus, part of strategic group map analysis always entails drawing conclusions about where on the map is the “best” place to be and why. Which companies/strategic groups are destined to prosper because of their positions? Which companies/strategic groups seem destined to struggle because of their positions? What accounts for why some parts of the map are better than others? Do big white spaces on the map correctly imply that these spaces are not attractive positions to be in or might one or more industry members be able to profitably create and capture new demand by moving into a particular white space?

Question 4: What Strategic Moves Are Rivals Likely to Make Next?

Unless a company pays attention to competitors' strategies and situations and has some inkling of what moves they will be making, it ends up flying blind into competitive battle. As in sports, scouting the opposition and trying to prepare for the actions close rivals are likely to take is essential to competing effectively against them. Gathering competitive intelligence about rivals' strategies, their financial performance, their resource strengths and weaknesses, the actions and plans they have announced, and the thinking and leadership styles of their top executives is valuable for predicting or anticipating the strategic moves competitors are likely to make next. The more a company can get into the minds of the managers of rival companies and anticipate rivals' moves, the better able it is to be ready with defensive countermoves, to craft its own strategic moves with some confidence about what market maneuvers to expect from rivals, and to capitalize on opportunities stemming from competitors' missteps or

Closely monitoring the actions of competitors and preparing a defense against their expected next moves reduces the risk of being caught napping and suffering a damaging loss of sales and profits.

strategy flaws. Failure to study rival companies well enough to accurately anticipate some of their probable competitive moves makes it (highly?) likely that a company will suffer unexpected declines in sales and profits because it is caught flat-footed or “surprised” by aggressive moves on the part of one or more rivals to grow sales and market share and thereby boost their profitability and overall performance.

Good clues about what actions a specific company is likely to undertake can often be gleaned from how well it is faring in the marketplace, the problems or weaknesses it needs to address, and how much pressure it is under to improve its financial and overall business performance.¹⁹ Rivals with good financial performance are likely to continue their present strategy with only minor fine-tuning. Poorly performing rivals are virtually certain to make fresh strategic moves. Ambitious rivals looking to move up in the industry ranks are strong candidates for launching new strategic offensives to pursue emerging market opportunities and exploit the vulnerabilities of weaker rivals. Other sources of clues about what actions a rival may take include company press releases, management letters to shareholders, presentations management has recently made to securities analysts, interviews of top executive by the business media, and such public documents as annual reports and 10-K filings.

Perhaps the most frequent reason why a company gets outcompeted by what it considers the “surprising” actions of rivals goes directly to the failure of its management to do a competent job of studying the situation of one or more rivals and recognizing their need to undertake certain actions in the marketplace to improve their market share and profitability.

Company managers can pose several useful questions to help predict the likely actions of important rivals:

- Which competitors have strategies that are producing good results—and thus are likely to make only minor strategic adjustments (other than increasing expenditures for one or more strategy elements in order to further boost their competitiveness and performance)?
- Which competitors are losing ground in the marketplace or otherwise struggling to come up with a good strategy—and thus are strong candidates for altering their prices, improving the appeal of their product offerings, perhaps moving to a different part of the strategic group map, and otherwise adjusting important elements of their strategy?
- Which competitors are poised to gain market share, and which ones seem destined to lose ground?
- Which competitors are likely to rank among the industry leaders five years from now? Do one or more up-and-coming competitors have powerful strategies and sufficient resource capabilities to overtake the current industry leader?
- Which rivals badly need to increase their unit sales and market share? What strategic options are they most likely to pursue: lowering prices, adding new models and styles, expanding their dealer networks, entering additional geographic markets, boosting advertising to build better brand-name awareness, acquiring a weaker competitor, or placing more emphasis on direct sales via their website?
- Which rivals are likely to enter new geographic markets or make major moves to substantially increase their sales and market share in a particular geographic region?
- Which rivals are strong candidates to expand their product offerings and enter new product segments where they do not currently have a presence?
- Which rivals are good candidates to be acquired? Which rivals (or an outsider with competitively valuable capabilities) might well acquire one or more industry rivals?

To succeed in predicting a competitor's next moves, company strategists need to have a good feel for each rival's situation, how its managers think, and what the rival's best strategic options are. Many companies have competitive intelligence units that sift through the available information to construct up-to-date strategic profiles

of rival firms. Doing the necessary detective work can be tedious and time-consuming, but scouting competitors well enough to anticipate their next moves allows managers to prepare effective countermoves (perhaps to even beat a rival to the punch) and to take rivals' probable actions into account in crafting their own best course of action.

Question 5: What Are the Key Factors for Future Competitive Success?

An industry's **key success factors (KSFs)** are those competitive factors that most affect industry members' ability to prosper in the marketplace—the particular strategy elements, product attributes, resource strengths, competitive capabilities, and market achievements that spell the difference between being a strong competitor and a weak competitor—and sometimes between profit and loss. KSFs by their very nature are so important to future competitive success that *all firms* in the industry must pay close attention to them or risk becoming a weak competitor and industry laggard. To indicate the significance of KSFs another way, how well a company's product offering, resources, and capabilities measure up against an industry's KSFs determines just how financially and competitively successful that company will be. Identifying KSFs, in light of the prevailing and anticipated industry and competitive conditions, is therefore always a top-priority analytical and strategy-making consideration. Company strategists need to understand the industry landscape well enough to separate the factors most important to competitive success from those that are less important.

CORE CONCEPT

Key success factors are the strategy elements, product attributes, resource strengths, competitive capabilities, and market achievements with the greatest impact on future competitive success in the marketplace.

KSFs vary from industry to industry, and even from time to time within the same industry, as driving forces and competitive conditions change. In the case of manufacturers of national and international brands of beer, the KSFs are full utilization of brewing capacity (to keep the fixed costs of manufacturing low), a strong network of wholesale distributors (to get the company's brand stocked and favorably presented in retail outlets, bars, restaurants, and sports arenas where beer is sold), and clever advertising and branding capabilities (to induce beer drinkers to buy the company's brand and thereby pull beer sales through the established wholesale/retail channels). In apparel manufacturing, the KSFs are appealing designs and color combinations (to create buyer interest) and low-cost manufacturing efficiency (to permit attractive retail pricing and ample profit margins).

Regardless of the circumstances, an industry's key success factors can be identified by asking three questions:

- On what basis do buyers of the industry's product or service choose between the competing brands of sellers? That is, what product or service attributes are crucial?
- Given the nature of competitive rivalry and the competitive forces prevailing in the marketplace, what resources and competitive capabilities must a company have to be competitively successful?
- What shortcomings are almost certain to put a company at a significant competitive disadvantage?

Only rarely are there more than five key factors for future competitive success. And even among these, two or three usually outrank the others in importance. Managers should therefore bear in mind the purpose of identifying KSFs—to determine which factors are *most important* to future competitive success—and resist the temptation to label a factor that has only minor importance as a KSF. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

Correctly diagnosing an industry's KSFs also raises a company's chances of crafting a sound strategy. The goal of company strategists should be to design a strategy that not only enables the company to *compare favorably* vis-à-vis rivals on each and every one of the industry's future KSFs but that also aims at being *distinctly better* than rivals on one (or possibly two) of the KSFs—*being distinctly better than rivals on one or two key success factors tends to translate into competitive advantage.*²⁰ The competitive advantage potential of such an approach to crafting a company's strategy stands in sharp contrast to what happens when company executives misdiagnose industry KSFs or discount their strategic importance. When a strategy falls far short of delivering competitive parity on the industry's KSFs, the company is destined to be a weak competitor and earn below-average profits. When a company's strategy puts a company somewhere in the middle of the pack of rivals relative to industry KSFs, its overall performance will likely approximate the industry average. Hence, making sure the company's strategy contains top-priority strategic actions aimed at comparing favorably with rivals on each and every KSF—and then going a step further to achieve competitive superiority on at least one KSF—is a powerful and rewarding approach to crafting a company's strategy.

To be a winner, a company's strategy must compare favorably with rivals on all industry KSFs and be competitively superior on one, maybe two, of the industry's KSFs.

Question 6: Is the Industry Outlook Conducive to Good Profitability?

The final step in evaluating the industry and competitive environment is to use the preceding analysis to decide whether the outlook for the industry presents the company with good prospects for attractive profitability and growth. The important factors on which to base such a conclusion include:

- Whether the industry and the company are being favorably or unfavorably impacted by macro-environmental factors.
- The industry's growth potential.
- The anticipated strength of competitive forces—the overriding issue here is whether competitive forces seem likely to intensify and squeeze industry profitability to subpar levels or whether the company should be able to earn good profits despite the expected strength of competitive forces.
- Whether and to what degree industry profitability will be favorably or unfavorably affected by the industry's driving forces.
- Whether the company is strongly or weakly positioned on the industry's strategic group map.
- How well the company's strategy, product offering, and capabilities stack up against industry KSFs.
- The degrees of risk and uncertainty in the industry's future.

As a general proposition, *the anticipated industry environment is fundamentally attractive if it presents a company with good opportunity for above-average profitability; the industry outlook is fundamentally unattractive if a company's profit prospects are unappealingly low.*

However, it is a mistake to view future conditions in a particular industry as being equally attractive or unattractive to all industry participants and all potential entrants.²¹ For instance, even though analysis reveals numerous factors that make an industry's outlook unattractive, a favorably situated and competitively capable company may nonetheless see ample opportunity to capitalize on the vulnerabilities of weaker rivals and significantly grow its revenues and profits. And even if an industry is deemed to have appealing potential for growth and profitability, a weak competitor may conclude that having to fight a steep uphill battle against much stronger

rivals holds little promise of eventual market success or even average profitability. Similarly, some industry outsiders may conclude that they have the resources and capabilities to readily hurdle the barriers to entering an attractive industry, while other outsiders conclude that the same industry is unattractive because of the difficulty of challenging current market leaders with their particular resources and competencies and/or because of the better opportunities they have elsewhere.

When a company decides an industry is fundamentally attractive, a strong case can be made that it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business. When a strong competitor concludes an industry is relatively unattractive and lacking in opportunity, it may elect to simply protect its present position, investing cautiously, if at all, and look for opportunities in other industries. A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business.

CORE CONCEPT

The degree to which an industry's outlook is attractive or unattractive is not the same for all industry participants and all potential entrants. Some companies may be strongly positioned with the strategies and competitive strengths to capture the opportunities an industry presents; others may not.

Key Points

Evaluating a company's external environment involves probing for answers to seven questions:

1. *To what extent are factors in the broad macro-environment acting to make the outlook for the industry and the company more or less attractive?* Industries and companies differ significantly as to how they are affected by developments and trends in the broad macro-environment. Identifying which of these is strategically relevant and their probable impact is the first step in understanding how attractively a company is situated in its external environment.
2. *What kinds of competitive forces are industry members facing, and how strong is each force?* The strength of competition is a composite of five forces: (1) the jockeying and market maneuvering among industry rivals, (2) the threat of new entrants into the market, (3) the market inroads being made by the sellers of substitutes, (4) supplier bargaining power, and (5) buyer bargaining power. All five must be examined force by force and their collective strength evaluated. Working through the five-forces model aids strategy-makers in crafting a strategy that is well-suited to prevailing competitive conditions and has good prospects for producing the best possible business results.
3. *What forces are driving changes in the industry, and what impact will these changes have on competitive intensity and industry profitability?* Industry and competitive conditions change because certain forces are creating incentives or pressures for change. The most common driving forces include changes in the long-term industry growth rate, increasing globalization, Internet-related developments, changing buyer demographics and uses of the product, product innovation, the entry or exit of major firms, changes in cost and efficiency, changing buyer preferences for standardized versus differentiated products or services, regulatory influences and government policy changes, changing societal and lifestyle factors, and reductions in uncertainty and business risk. Once an industry's driving forces have been identified, the analytical task becomes one of determining whether the driving forces, taken together, are acting to make the industry environment more or less attractive. Are the driving forces causing demand for the industry's product to increase or decrease? Are the driving forces acting to make competition more or less intense? Will the driving forces lead to higher or lower industry profitability?
4. *What market positions do industry rivals occupy—who is strongly positioned and who is not?* Strategic group mapping is a valuable tool for understanding the similarities, differences, strengths, and weaknesses inherent in the market positions of rival companies. Rivals in the same or nearby strategic groups are close competitors, whereas companies in distant strategic groups usually pose little or no immediate

threat. The lesson of strategic group mapping is that some positions on the map are more favorable than others. The profit potential of different strategic groups varies due to strengths and weaknesses in each group's market position. Often, industry driving forces and competitive pressures favor some strategic groups and hurt others.

5. *What strategic moves are rivals likely to make next?* Scouting competitors well enough to anticipate their actions can help a company prepare effective countermoves (perhaps even beating a rival to the punch) and allows managers to take rivals' probable actions into account when designing their own company's best course of action. Managers who fail to study competitors risk being caught unprepared by rivals' strategic moves.
6. *What are the key factors for future competitive success?* An industry's key success factors (KSFs) are the particular strategy elements, product attributes, competitive capabilities, and business outcomes that spell the difference between being a strong competitor and a weak competitor—and sometimes between profit and loss. KSFs are so important to competitive success that *all firms* in the industry must pay close attention to them or risk becoming an industry also-ran. To be a winner, a company's strategy must compare favorably with rivals on all industry KSFs and be competitively superior on one, maybe two, of the industry's KSFs.
7. *Is the industry outlook conducive to good profitability?* An industry's outlook is fundamentally attractive if it presents a company with good opportunity for above-average profitability; its outlook is fundamentally unattractive when a company's profit prospects are unappealingly low. On occasion, an industry with a bleak outlook is still very attractive to a favorably situated company with the capabilities to take business away from weaker rivals.

Clear insightful diagnosis of a company's external environment is an essential first step in crafting strategies that are well matched to industry and competitive conditions and, therefore, have a good chance to produce the best possible business results. To engage in cutting-edge strategic thinking about the external environment, managers must know what questions to pose and what analytical tools to use in answering these questions. That is why this chapter has concentrated on suggesting the right questions to ask, explaining concepts and analytical approaches, and indicating the kinds of things to look for.