Chapter 2: External Environment Analysis: Opportunities and Threats

Learning Objectives

Studying this chapter should provide you with the knowledge t

- Explain the importance of correctly identifying and choosing a firm's industries and markets.
- Identify and measure the five major forces that shape average firm profitability within industries to evaluate the overall attractiveness of an industry.
- Identify the factors in the general environment that affect firm and industry profitability.

Professors Purpose

The purpose of this chapter is to introduce students to the forces that influence inter- and intra-industries. Students will learn how to apply Michael Porter's Five Forces framework to evaluate the attractiveness of industries in the broader scope of the general environment. The Five forces framework will be basis of analysis for the remainder of the course.
This strategy tool will be learned through class lecture, end of chapter assignments, mini-cases in chapter and finally with the Coca Cola case.

Please note that the "Presenters Notes" are in the PowerPoint slide deck give a brief script for lecture and can be used as a guide.

Answers to Review Questions

1. Why is it important for a firm to accurately determine what industry it is in?
   So that executives can identify who their real competitors are and the economic forces that will influence the strategies they hope to pursue. Industries also differ in terms of their profitability and performance, and identifying the right industry tells managers and investors what types of returns to expect.

2. How should a firm decide what industry it is in?
   Firms should use the U. S. Government's NAICS codes to determine their industry.

3. What are the five major industry forces? How do they shape average profitability in an industry?

The five forces are: Barriers to (or threat of) Entry, Supplier Power, Buyer Power, Presence of Substitutes, and Competitive Rivalry. The impacts on average profitability are
Threat of Entry—the lower the threat the higher the average profitability
Supplier Power—the lower supplier power, the higher the average profitability
Buyer Power—the lower buyer power, the higher the average profitability
Substitution—the lower the threat of substitution, the higher the average profitability
Rivalry—the lower the degree of rivalry, the higher the average profitability.

4. What factors determine the intensity of rivalry?
   (1) the number and size of competitors; (2) standardization and perishability of products; (3) costs to buyers of switching to another product; (4) growth in demand for products; (5) levels of unused production capacity or fixed costs; and (6) the difficulty for firms of leaving the industry.

5. Explain why increased buyer concentration would increase buyer power.
   Increased buyer concentration (fewer buyers relative to the number of sellers) gives buyers increased pricing leverage over the firm. This is because firms have to compete to sell to fewer buyers, and orders tend to be larger.

6. Explain what it means for suppliers to have a credible threat of forward integration.
   This happens when a supplier can easily compete with the firm. It may have the same technology, or it may already have access to the same distribution system. With very little expenditure, the supplier could produce and sell the same product as the firm.

7. What factors determine the intensity of the threat of new entrants?
   The presence of economies of scale, experience, or learning; other cost advantages; Capital requirements to enter the industry; network effects, government policies and regulations.

8. What are substitutes?
   A product that is fundamentally different yet serves the same basic function or purpose as another product

9. What are the seven general environmental factors that affect industry profitability?
   Complementary products or services
   Technological change
   General economic conditions
   Population demographics
   Global competitive forces
   Political, legal, and regulatory forces,
   Social/Cultural forces
   Ecological/Natural Environment

10. How does each of the eight general environmental factors influence industry profitability?
    Complementary products or services—raise the attractiveness of the industry's products, and hence its price
    Technological change—technology can either enhance profitability (by creating new complements) or it can destroy profitability by creating a new and better substitute product.
    General economic conditions—General economic conditions, such as interest rates, affect the cost of capital as well as consumer's overall willingness to spend.
    Population demographics—affect the composition, and number, of customers. An aging population is bad for toys and games, but good for vacations and retirement living.
    Global competitive forces—Global competitive forces can drive down profitability by removing trade barriers and inviting global competitors to enter the market. However, globalization also helps profitability by giving firms access to new, and sometimes very large, markets.
    Political, legal, and regulatory forces—Regulations can increase the costs of doing business, or make some products and services less attractive to buyers. Conversely, government regulations can also raise barriers to entry and increase industry profitability.
    Social/Cultural forces—this force influences consumer tastes and preferences. Changes in tastes can reduce profitability (think of the fast food industry), or it can raise profitability (think of all the accessories that make your smartphone more attractive and easier to use).
    Ecological/Natural Environment—emerging concerns about the natural environment may open new and profitable industries, such as renewable energy. Threats of ecological damage can invite government regulations or activist concerns. These would drive down profitability.

11. How do the eight general environmental factors affect the five industry forces?
    The general environmental forces work primarily to make the five forces dynamic. Often it is changes in the larger environment that causes a significant shift in each of the 5 forces.

12. What are the elements of a complete external analysis?
    Managers should begin by defining the industry. They should then analyze and evaluate the 5 forces, and then they should examine the current—and future—impacts of the eight general environmental forces on the industry. It is important to understand how the industry has evolved over time, and so a complete analysis will consider how each force or element has changed over time, and what future changes might be reasonable.

Teaching Note

Coca-Cola, Pepsi, and the Shifting Landscape of the Carbonated Soft Drink Industry

Teaching Objectives

This case provides an understanding of the underlying economics of an industry and its relationship to average industry profits. The concentrate industry is, on average, more attractive than bottling. It also provides students with an opportunity to create an entry strategy for a new player in the concentrate industry.

After completing this case, students should have a much clearer understanding of the five forces that influence an industry's attractiveness. They also should have an increased ability to analyze each of those five forces to assess and measure the overall attractiveness of a given industry. The case provides all of the needed information for students to use the supplier power and rivalry five forces tools from chapter 2.

Study Questions

1. Analyze the structure (Porter's 5 Forces) of the soft drink industry. Why are Coke and Pepsi so profitable? What prevent other firms from entering this industry and accessing some of those high profits?
2. Compare the economics (costs and profits) of soft drinks (concentrate) versus bottlers. Why is the concentrate business more profitable than the bottling business? Why do you think Coke & Pepsi are in the bottling business?
3. Team Assignment: Create a 5 year proforma in Excel which projects the revenues, costs, and profits (both earnings before interest, taxes, and amortization (EBITDA) and earnings before taxes (EBT) for a company who enters the U.S. carbonated soft drink industry and who attempts to build a 10% market share position in the U.S. carbonated soft drink industry within a five year time period (please include fixed and variable costs in your analysis). To calculate interest expense, assume that you will need to raise 50% of the capital you require through bank financing at 10% interest. To calculate depreciation expense, assume that only a niche player (with less than 5% market share) can access the bottlers/distributors of Coke or Pepsi, which means you will need to build bottling plants (which you can depreciate using straight line depreciation over a 30 year

life). Please provide your assumptions along with a one half page description of your market entry strategy.

Teaching Plan

I. Taste Test	15 min
II. Board Exercise: Concentrate Environment	30 min
III. Board Exercise: Comparison to Bottling Environment	15 min
IV. Conclusion	10 min

I. Taste Test

While not required, this activity may help students understand more clearly that Coke & Pepsi are more differentiated by brand than they are by product.

In preparation for this activity, you will need a bottle of Coke, Pepsi, and generic cola. It is best to put each brand in a pitcher or other type of generic container as the two liter bottles are distinctive in appearance. Make sure you know which brand is in which container. This can be done with a number taped to the bottom of the container. Place each container on a table with a number in front of it. The students will use that number to identify which brand they think they are tasting.

Ask if any students drink a lot of cola and have a preference for a particular brand. At the end of the exercise you will specifically ask those students if they correctly identified each brand and if they chose the right one as their favorite.

Write Coke, Pepsi, and Generic on the board. Have either all or a subset of students taste a sample from each bottle and write down the number of the container beneath the brand they believe they are tasting. While some professors like to use a subset of students to speed up the exercise letting all students do the taste test really peaks their interest and engages them in the rest of the lesson. Also have the students select which cola they most like by placing an asterisk next to that selection on the board. After each student has completed the test taste, reveal to them which soda was which. Ask those who drink a lot of cola and were sure they could tell the difference if they got it right. While some may correctly identify all three, most of the students will likely not. It may also be interesting to note that some students that have a favorite cola (Pepsi or Coke) will mistakenly choose another cola as their favorite (e.g. Pepsi drinkers may mistakenly identify Coke or the generic brand as Pepsi). While with some classes the majority identify each cola correctly most of the time they do not and the generic cola is often chosen as the overall favorite.

Question: What does it mean that you can't tell the difference?

The purpose of the Concentrate & Bottling Environment sections is to help students more concretely identify the sources of Coke & Pepsi's profitability. These sections also give students an opportunity to identify what they would do to operate profitably in these environments (see Study Question #3).

II. Concentrate Environment

Question: Coke & Pepsi make roughly 80% margins on a product that, according to the taste test, isn't very differentiated at all. How can you explain how a company that sells a non-differentiated product makes higher margins than companies that make very differentiated products such as Intel or Apple?

As students answer, help them see that the profitability does not solely come from brand equity. For example, it may be useful to refer students back to the taste test and ask a question such as: *If brand is the source of profitability, does that mean that Coke and Pepsi have convinced us that their product is better than the generic brand even though you can't really taste a difference between them?*

During this discussion, it is likely that students will mention Coke & Pepsi's spending on marketing and advertising ($234m & 136m respectively). As they do so, it may be useful to ask the following:

At this point, students should be describing characteristics of the competitive environment other than brand equity. A description of the concentrate industry environment is given below for reference.

This works well as a board exercise. Two approaches – one is to list the five forces on the board and fill in the various elements as students bring them up. Another approach, the one I typically use, is to ask for a five force, and then ask students to rate it low, medium, or high, and analyze why. As they do so write a summary of their analysis on the board. It is helpful to push the students to use the language from the chapter and identify the exact reasons that a force is high, medium, or low. For instance, one reason rivalry is low is because the concentrate manufacturing industry has few firms in it and they do not compete on price with their primary customers, the bottlers. Below is a simplified summary.

If you had the students use the rivalry tool as an experiential exercise when covering rivalry you may want to show the answers to five forces worksheet so students can compare it with their answers and see how a thorough analysis can inform the more informal analysis they are doing in class.

Threat of New Entrants

LOW- due to barriers such as limited shelf space* and the high brand equities of incumbents

Supplier Power

LOW - All concentrate inputs are commodities.

Competitive Rivalry

LOW - Coke & Pepsi have a large share of a shrinking market. Little price competition. Few firms in the industry.

Buyer Power

LOW – The Bottlers are the buyers. They are locked into long term contracts with no ability to switch suppliers.

Threat of Substitutes

HIGH – multiple substitutes – any other beverage. Get students to see how Coke and Pepsi have managed this threat by purchasing major substitute brands.

*Besides limited shelf space, limited fountain space and costs of vending distribution also create barriers to entry.

Question: Why can't another company successfully enter the concentrate industry by simply investing a large amount into marketing and advertising?

If you had the students do study question #3 this would be the time to show the excel spreadsheet showing the 5 year proforma, focusing on the costs of advertising, creating a bottler network, and paying for shelf space.

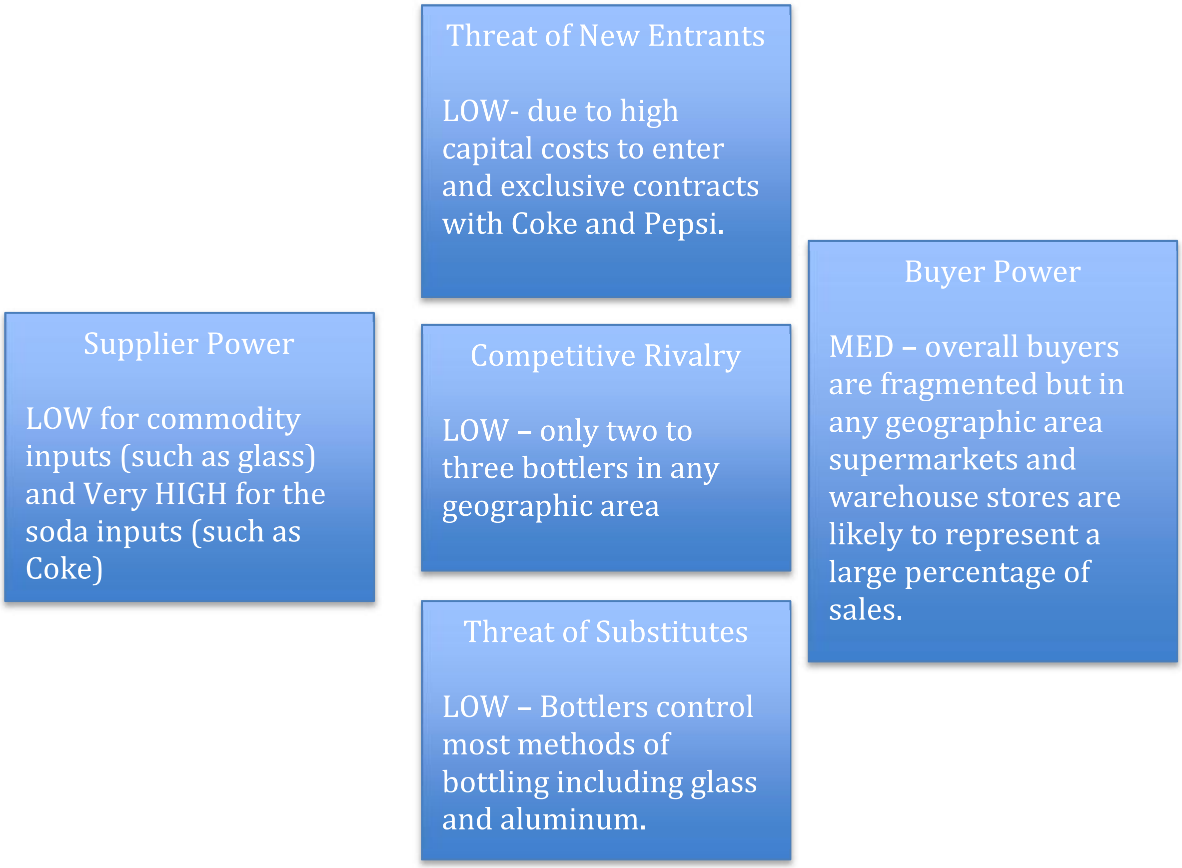
III. Bottling Environment

Question: Compare the attractiveness of the concentrate industry with the bottling industry? Why is the concentrate industry more attractive than the bottling industry?

Push students to apply the 5 Forces model to compare the two industries. This works well as a board exercise. As with the concentrate manufacturers ask students for a five force, have them choose if the threat is low, medium, or high, and then analyze why.

If you had the students use the supplier power tool as an experiential exercise when covering supplier power you may want to show the answers to five forces worksheet so students can compare it with their answers and see how a thorough analysis can inform the more informal analysis they are doing in class.

A comparison between the two industries can be very instructive. At this point ask the students if the industries are attractive. On the surface both look attractive. However, you can point out that the concentrate manufacturers enjoy high profit margins while the bottlers do not. Ask the students why. While the bottling industry looks very attractive the lesson to be learned is that it can take only one of the five forces to be a major threat to industry profitability. In this case the extremely high supplier power that the concentrate manufacturers enjoy allows them to siphon off any extra profits from the bottling industry.



Question: Why are Coke and Pepsi in the bottling business if it is so much less attractive than concentrate?

Although the concentrate environment is attractive by itself, their presence in the bottling business is what protects the concentrate industry due to the increased barriers to entry. The purpose of this section is to help students understand why it would be difficult to directly enter the concentrate market and why Coke & Pepsi are experiencing such great profits.

IV. Conclusion

This case provides an understanding of the underlying economics of an industry and its relationship to average industry profits. The concentrate industry is, on average, more attractive than bottling.

Entry into the concentrate industry is limited by barriers to entry:

- Brand Equity
- Bottling/Franchise System
- Limited Shelf Space

Relative to bottling, concentrate has:

Greater bargaining power over suppliers and buyers
A more attractive industry structure overall

STRATEGIC MANAGEMENT

CONCEPTS AND TOOLS FOR CREATING REAL WORLD STRATEGY

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CHAPTER 2

Industry Analysis And Firm Performance

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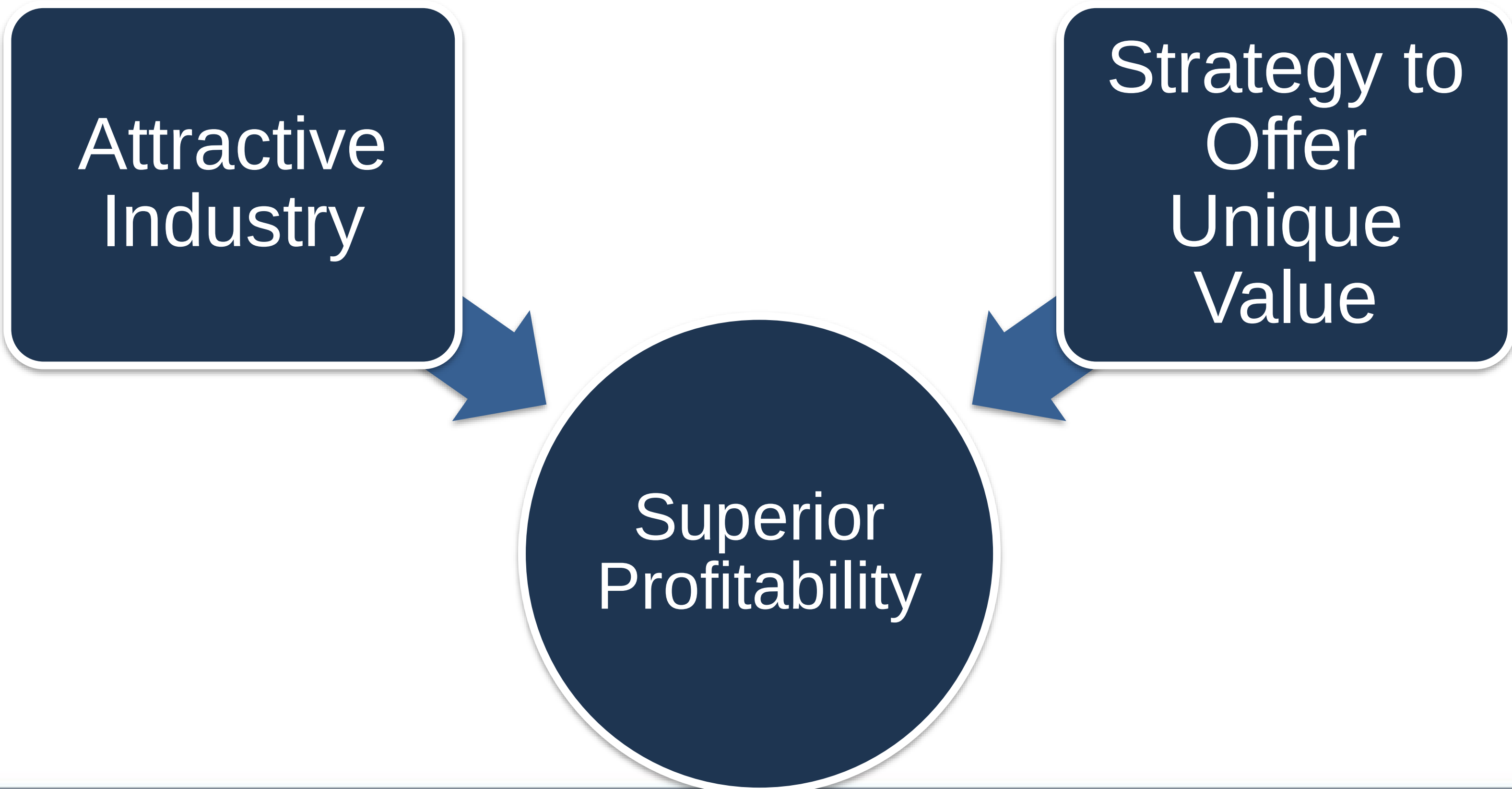
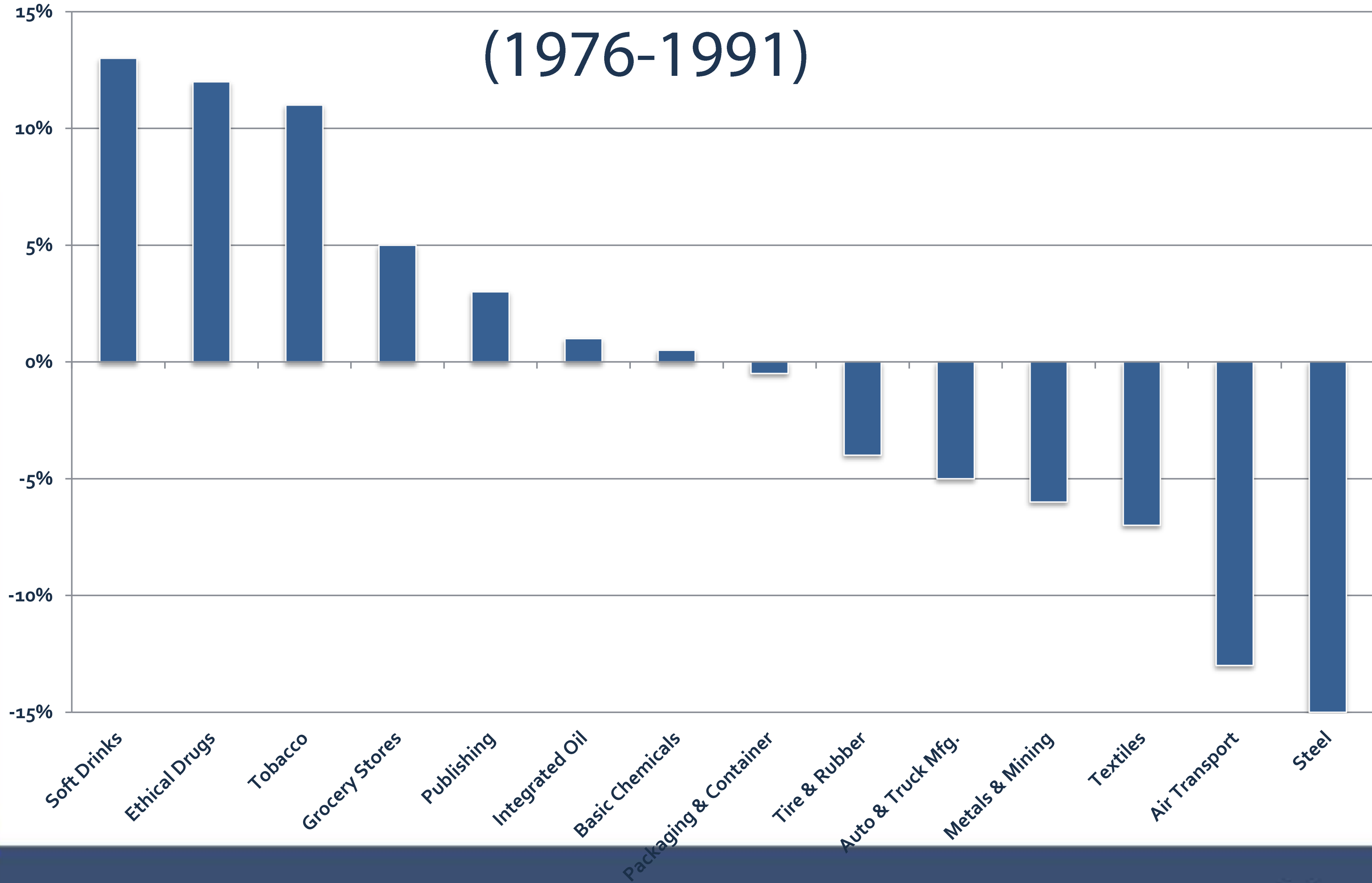
Sources of Superior Profitability

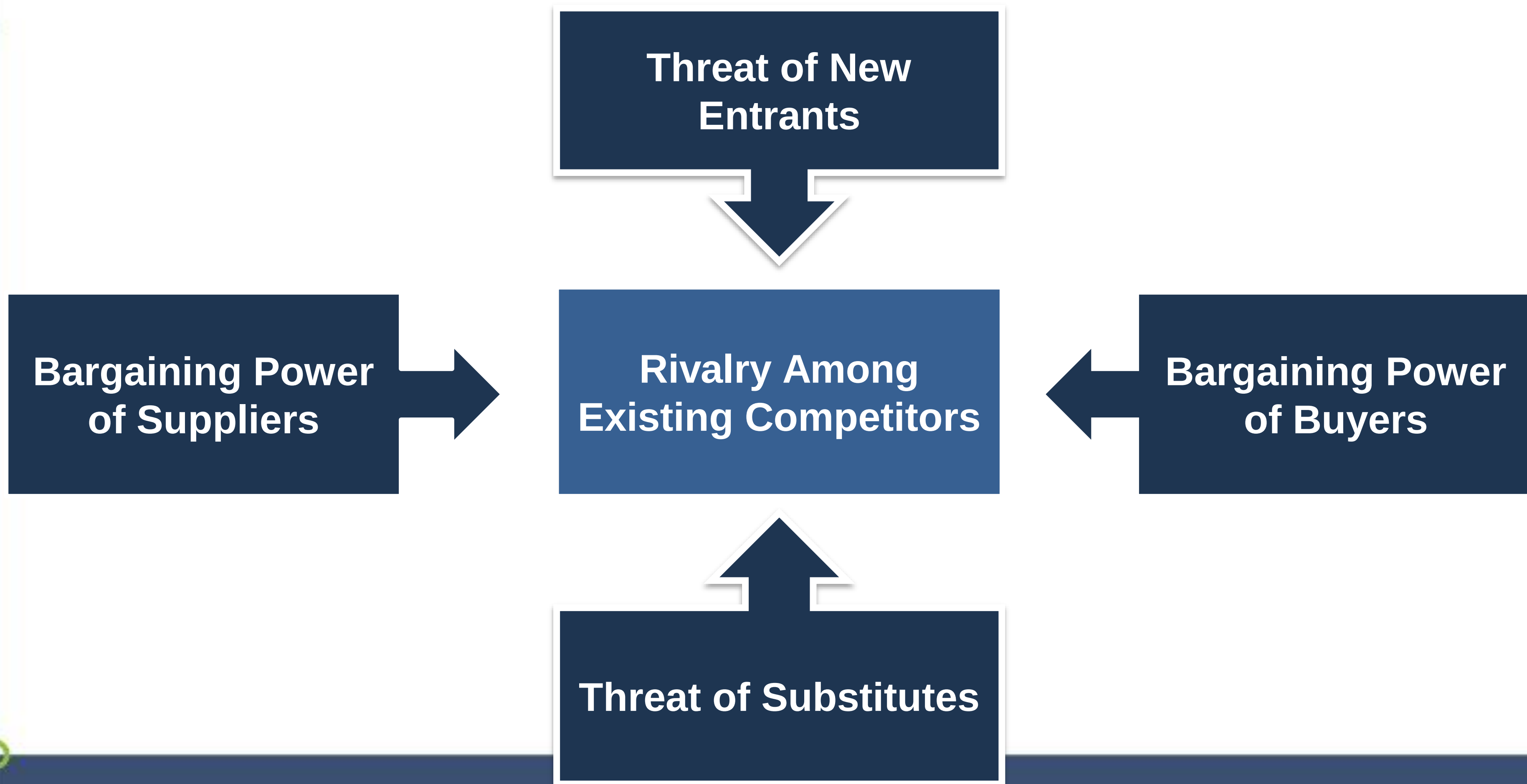


Historical Profitability of Industries



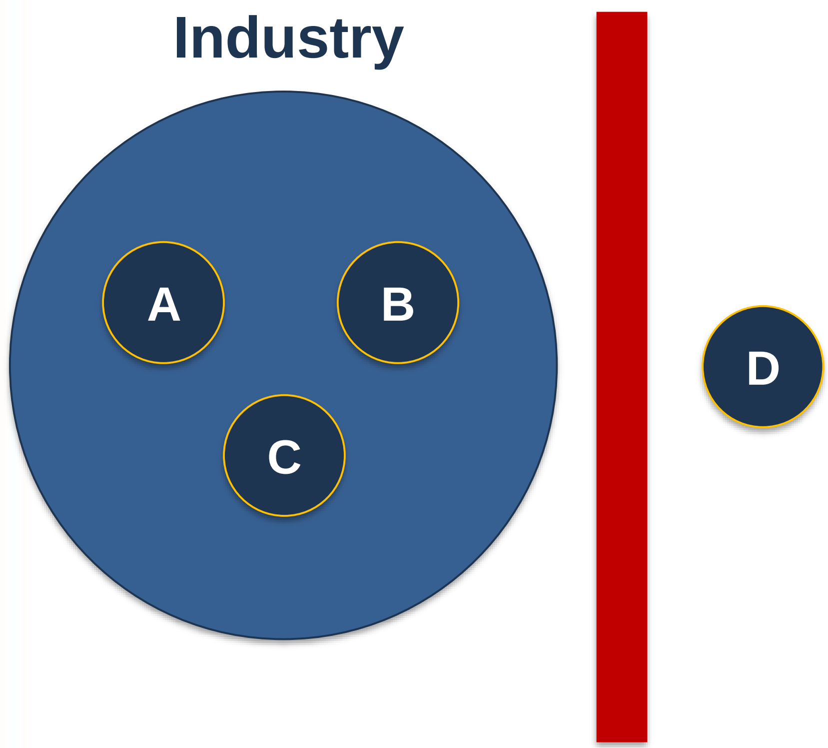
“Industry Structure” Perspective

“Five Forces” Analysis of Competitive Strategy



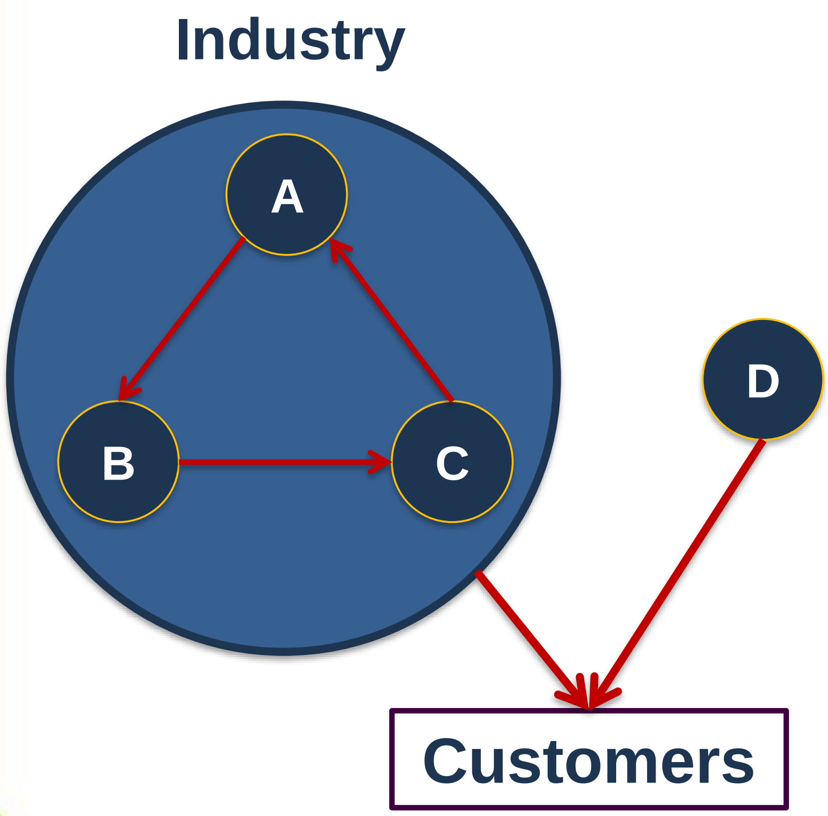
Barriers to Entry

What Factors Keep Potential Competitors Out?



- **Scale economies** (MES is a significant proportion of industry demand)
  - *e.g., aerospace industry*
- **Capital requirements** (combined with uncertainty or inefficient capital mkts)
  - *e.g., aerospace industry*
- **Scope economies**
  - *e.g., retailing*
- **Switching costs** (due to learning, customer investment, loyalty programs, network effects)
  - *e.g., Windows operating system; eBay*
- **Access to scarce resources** (e.g. inputs, distribution, locations)
  - *e.g., DeBeers (diamonds), Coke (distribution)*
- **Learning Curve**
  - e.g., Honda motorcycles (motors)
- **Product Complexity**
  - e.g., supercomputers, microprocessors
- **Entry deterring regulations**
  - *e.g., tariffs;*

What Alternatives are Available to Customers (Threat of Substitutes)



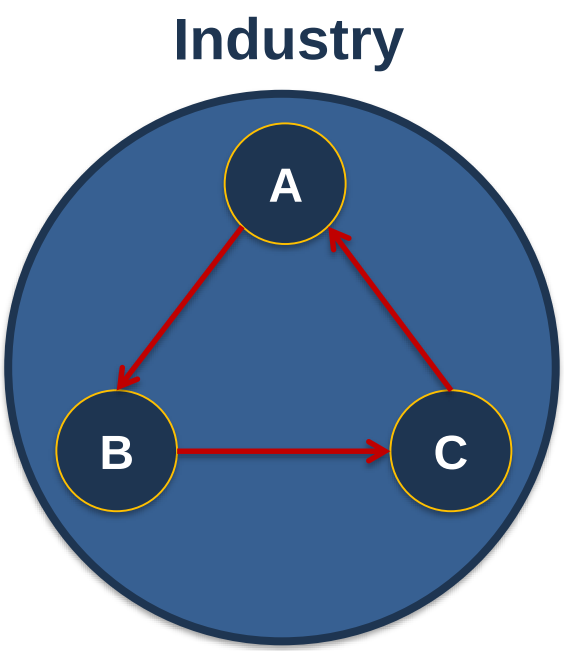
Direct substitution with similar or the same functionality

- *Diesel vs gas engines*
- *DirecTV vs cable*

Be Your Own Substitute

- *Starbucks acquiring Seattle's best coffee (partnerships with both Barnes & Noble and Borders)*
- *MTV (acquiring other music channels (VH1, Country)*

Why Industries are More or Less "Competitive" (Nature of Focus on Rivalry)



Competitive rivalry can focus on many factors, including price, quality, technology, features, service, etc.

Factors

- Number of direct competitors & substitutes
  - *High rivalry with more competitors and more substitutes.*
- Industry growth rates
  - *High rivalry with slow growth and in high growth industries when there are strong first mover advantages (e.g., eBay).*
- Exit barriers
  - *High rivalry when companies must make significant investments in non-redeployable assets (e.g., steel industry; bowling alleys).*
- Fixed costs
  - *High rivalry when fixed to variable cost ratio is high (need to keep volumes high to spread fixed costs).*
- Lack of product differentiation
  - *High rivalry when there are minor or no differences in functionality and performance of products or services.*
- Switching costs
  - *High rivalry when switching costs among companies are low (e.g., long distance telephone).*

What can be done to neutralize bargaining power of **buyers**?

Differentiate your offering so that it uniquely responds to only certain buyer needs.

Buyers have less power when your product offers something that is unique.

Narrow the options of the buyer through market consolidation or exclusive alliances (or aggressive pricing or cross subsidizing to eliminate competitors).

Buyers have less power when there are fewer options.

Create switching costs for your buyers.

Buyers have less power when there are greater costs to switch due learning, specialized investments, loyalty programs, network effects.

WHAT CAN BE DONE TO NEUTRALIZE BARGAINING POWER OF **SUPPLIERS**?

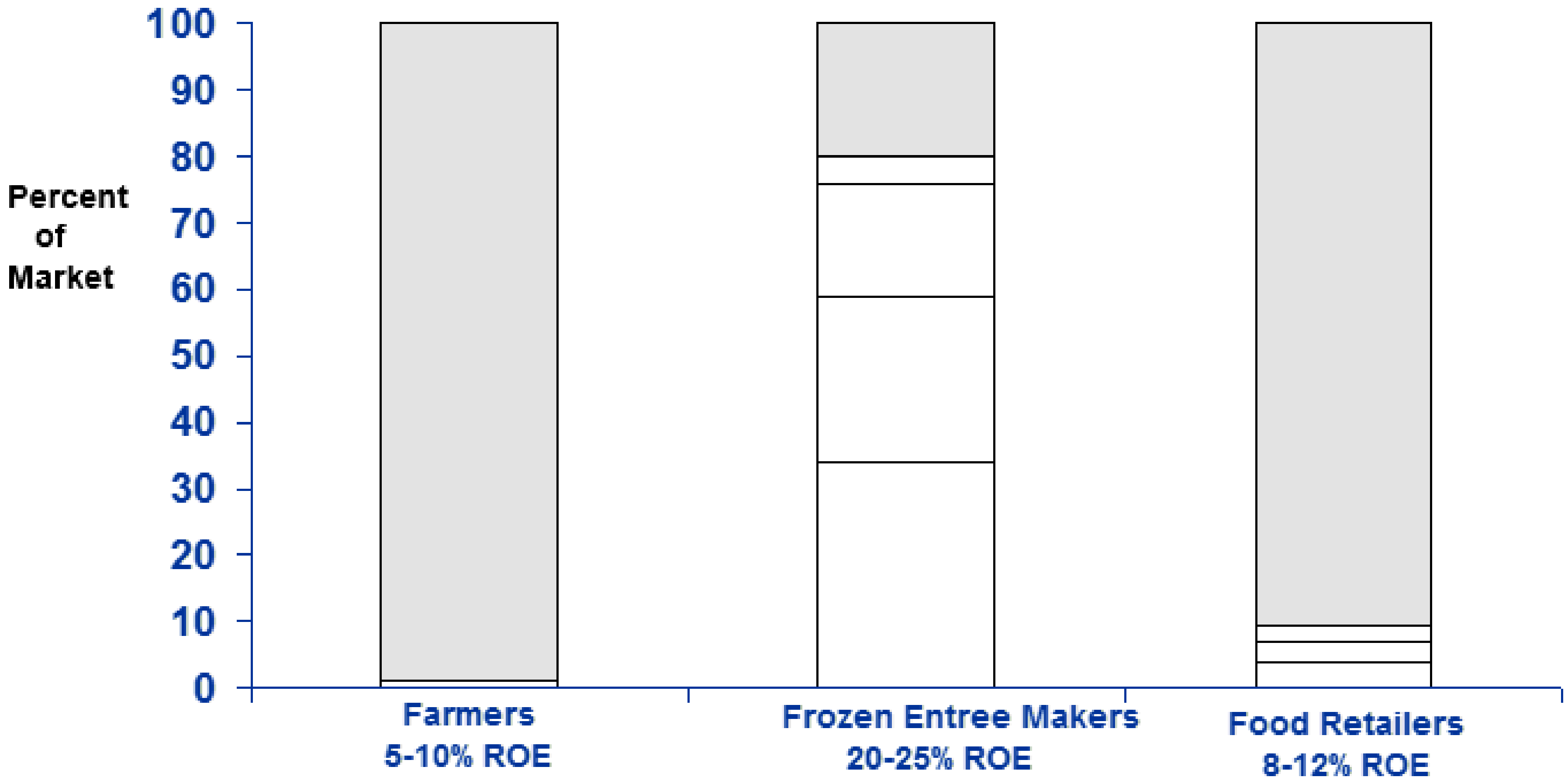
Narrow the sell options of the supplier through market consolidation, merger or alliances.

Develop alternative sources of supply.

Ally with a supplier and encourage the supplier to make non-redeploy-able (transaction-specific) investments to provide inputs to you as the customer at lowest possible cost.

Diversify your product offerings to diminish dependence of your business on any particular supplier

How Industry Structure Influences Profitability



Airlines

THREAT OF ENTRY
HIGH
•entrants have cost advantages
•moderate capital requirements
•little product differentiation
•deregulation of governmental barriers

BUYER POWER
MEDIUM/HIGH
- Buyers extremely price sensitive
- Good access to information
- Low switching costs

INDUSTRY RIVALRY
HIGH
•many companies
•little differentiation
•excess capacity
•high fixed/variable costs
•cyclical demand

SUPPLIER POWER
HIGH
•strong labor unions
•concentrated aircraft makers

THREAT OF SUBSTITUTES
MEDIUM
•Autos/train for short distances

Pharmaceuticals

THREAT OF ENTRY
LOW
•economies of scale
•capital requirements for R&D and clinical trials (more than $300 million per drug).
•product differentiation
•control of distribution channels
•patent protection

BUYER POWER
LOW
Physician as buyer:
- Not price sensitive
- No bargaining power.

(Changing with managed care.)

INDUSTRY RIVALRY
LOW-MED
•high concentration
•product differentiation
•patent protection
•steady demand growth
•no cyclical fluctuations of demand

SUPPLIER POWER
LOW
Suppliers provide mostly commodity inputs

THREAT OF SUBSTITUTES
LOW
No substitutes.
(Changing as managed care encourages generics.)

Entry and Profitability

Top 10 Industries from 1990-2000

Industry	Incumbent ROA	Number of Entrants	Rate of Entry	Entrants' ROA	Profitable Entrants' ROA
1. Software	21%	675	90%	-4%	14%
2. Research Services	20%	16	67%	12%	14%
3. Semiconductors	18%	141	74%	6%	11%
4. Athletic Footwear	18%	3	43%	-5%	5%
5. Apparel	17%	9	47%	16%	26%
6. Beverages	17%	6	67%	-1%	9%
7. Testing Laboratories	17%	6	60%	7%	11%
8. Credit Rating Agencies	16%	10	71%	19%	23%
9. Grain Mill Products	15%	15	68%	5%	5%
10. Sugar & Confectionary Products	15%	8	42%	-3%	10%
Average of Top Ten Industries	17.9%	89	85%	1.6%	11%
Average of All Other Industries	3.9%	19	70%	2.3%	3%

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

Do Barriers To Entry Thwart Firms From Attempting Entry On Profitable Markets?

No – The Top 10 most profitable markets have almost five times as many entrants as less profitable markets

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

DO ENTRANTS TO THE MOST ATTRACTIVE MARKETS ENCOUNTER ENTRY BARRIERS?

- Yes - New entrants to Top 10 most profitable markets earn returns 30% lower than entrants elsewhere
- *However*, considering only *profitable* entrants to Top 10 markets, they earn, on average
  - *7 times* the returns of all entrants into top markets
  - *4 times* the returns of profitable entrants elsewhere

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

HOW DO PROFITABLE FIRMS SUCCESSFULLY ENTER ATTRACTIVE MARKETS?

Through *Indirect Assault*

Successful entrants use strategies that allow them to stay under the radar screen of powerful incumbents and avoid incumbent retaliation

In general, the more indirect the assault, the more successful it is

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

How to Launch an Indirect Assault

To create successful **Indirect Assaults,** Profitable entrants to top markets *combine at least two out of three* approaches…

1. Leverage existing assets

- Companies leverage excess capacity in existing assets, often supplementing their resources with a partner's, to overcome costly entry barriers at minimal cost

2. Reconfigure the value chain

- Entrants change the activities or the sequence of activities they perform to deliver value to customers.

3. Exploit a niche

- Entrants develop offerings that appeal only to some customers, particularly those that are over- or under-served by existing incumbent offerings.

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

PROCESS FOR SUCCESSFUL ENTRY

Identify Specific Barriers to Entry in the Industry

- **E.g., Beverage Industry's three major barriers to entry:**
  - **Bottling**
  - **Shelf space**
  - **Brand awareness**

Develop a Strategy to Eliminate/Overcome Each Barrier

- **Bottling (Wal-Mart: Used Cotts, largest private label bottler)**
- **Shelf space (leveraged Wal-Mart stores)**
- **Brand awareness (leveraged "Sam's Choice" and "Wal-Mart")**

Avoid Direct Assault on Incumbent's Customers

- **Wal-Mart focused on a niche: price sensitive customers**

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

Looking for Entry Opportunities

Can We Reconfigure the Value Chain?		
Can we use new technologies or perform activities in this industry in ways that weren't possible until recently?	Can we apply a business model from another industry to this one? (e.g., Netflix applying the Amazon-like model to DVD rentals).	Can we modularize the existing value chain, either by recombining steps or by substituting ones from different value chains? (e.g., Usana Health using multilevel distribution to the nutritional supplements industry).

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

Looking for Entry Opportunities

Can We Find a Niche?

An entrant will be better able to create a niche if it can answer yes to the following questions:

In this market, to customers care about a large number of features?	Do customers vary significantly in their preferences?	Are there distinctive groups of customers who are not well served by current offerings?	Are there rebel customers who, in an attempt to maintain a nonconformist identity, avoid mainstream products?

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

Looking for Entry Opportunities

Can We Leverage our Assets and Resources?

Do we, or potential partners, have excess capacity in existing tangible, or intangible, resources that are related in some way to the target industry's:

- Customers
- Distribution Channels
- Inputs
- Processes
- Technologies

Source: David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," *Harvard Business Review*, May 2007

TAKEAWAYS

Use Indirect Assault

When companies combine two or more of the basic entry strategies—leverage, niche, reconfigure—it increases the chances that incumbents will find it difficult to respond or will choose to ignore the entry.

Close the Door Behind You

Create barriers to entry by securing scarce inputs or locations, investing preemptively in capacity, generating network effects, or developing cost advantages by racing down the experience curve (e.g., Jet Blue acquiring LiveTV; purchasing all of Embraer capacity).

…kets,” *Harvard Business Review*, May 2007

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