chapter 3

Evaluating a Company's External Environment

LEARNING OBJECTIVES

LO1 Identify factors in a company's broad macro-environment that may have strategic significance.

LO2 Recognize the factors that cause competition in an industry to be fierce, more or less normal, or relatively weak.

LO3 Become adept at mapping the market positions of key groups of industry rivals.

LO4 Learn how to determine whether an industry's outlook presents a company with sufficiently attractive opportunities for growth and profitability.

In Chapter 2, we learned that the strategy formulation, strategy execution process begins with an appraisal of the company's present situation. The company's situation includes two facets: (1) the competitive conditions in the industry in which the company operates—its external environment; and (2) its resources and organizational capabilities—its internal environment.

Charting a company's long-term direction, conceiving its customer value proposition, setting objectives, or crafting a strategy without first gaining an understanding of the company's external and internal environments hamstrings attempts to build competitive advantage and boost company performance. Indeed, the first test of a winning strategy inquires, *"How well does the strategy fit the company's situation?"*

This chapter presents the concepts and analytical tools for zeroing in on a single-business company's external environment. Attention centers on the competitive arena in which the company operates, the drivers of market change, the market positions of rival companies, and the factors that determine competitive success. Chapter 4 explores the methods of evaluating a company's internal circumstances and competitiveness.

Evaluating the Strategically Relevant Components of a Company's Macro-Environment

LO1 Identify factors in a company's broad macro-environment that may have strategic significance.

A company's external environment includes the immediate industry and competitive environment and broader macro-environmental factors such as general economic conditions, societal values and cultural norms, political factors, the legal and regulatory environment, ecological considerations, and technological factors. These two levels of a company's external environment—the broad outer ring macro-environment and immediate inner ring industry and competitive environment—are illustrated in Figure 3.1. Strictly speaking, a company's **macro-environment** encompasses all of the *relevant factors* making up the broad environmental context in which a company operates; by *relevant,* we mean the factors are important enough that they should shape management's decisions regarding the company's long-term direction, objectives, strategy, and business model. The relevance of macro-environmental factors can be evaluated using **PESTEL analysis,** an acronym for the six principal components of the macro-environment: political factors, economic conditions in the firm's general environment, sociocultural forces, technological factors, environmental forces, and legal/regulatory factors. Table 3.1 provides a description of each of the six PESTEL components of the macro-environment.

CORE CONCEPT

The **macro-environment** encompasses the broad environmental context in which a company is situated and is comprised of six principal components: political factors, economic conditions, sociocultural forces, technological factors, environmental factors, and legal/regulatory conditions.

PESTEL analysis can be used to assess the strategic relevance of the six principal components of the macro-environment: political, economic, social, technological, environmental, and legal forces.

The impact of outer ring macro-environmental factors on a company's choice of strategy can be big or small. But even if the factors of the macro-environment change slowly or are likely to have a low impact on the company's

FIGURE 3.1 **The Components of a Company's External Environment**

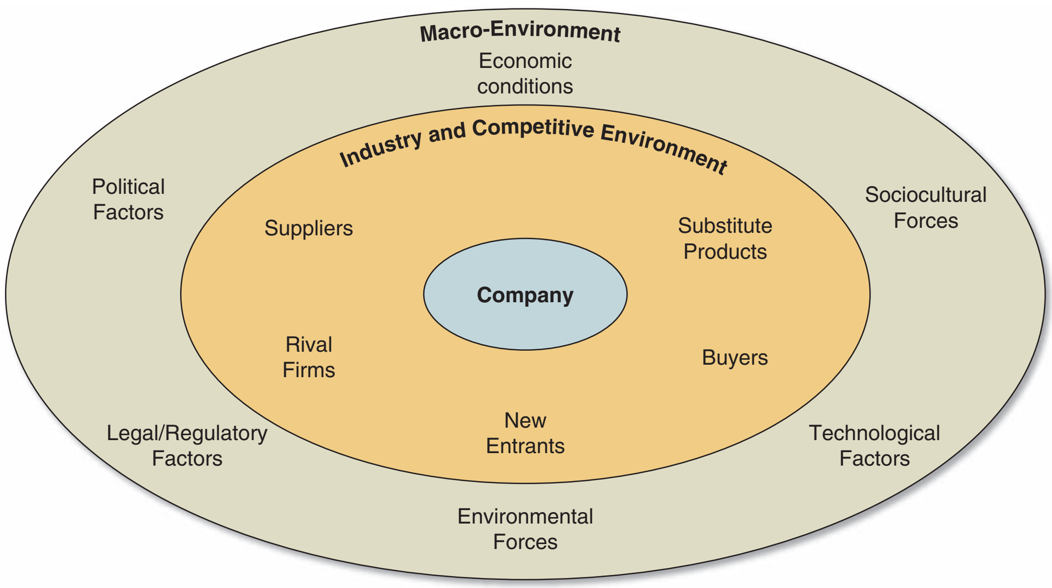


TABLE 3.1

The Six Components of the Macro-Environment Included in a PESTEL Analysis

Component	Description
Political factors	These factors include political policies and processes, including the extent to which a government intervenes in the economy. They include such matters as tax policy, fiscal policy, tariffs, the political climate, and the strength of institutions such as the federal banking system. Some political factors, such as bailouts, are industry-specific. Others, such as energy policy, affect certain types of industries (energy producers and heavy users of energy) more than others.
Economic conditions	Economic conditions include the general economic climate and specific factors such as interest rates, exchange rates, the inflation rate, the unemployment rate, the rate of economic growth, trade deficits or surpluses, savings rates, and per capita domestic product. Economic factors also include conditions in the markets for stocks and bonds, which can affect consumer confidence and discretionary income. Some industries, such as construction, are particularly vulnerable to economic downturns but are positively affected by factors such as low interest rates. Others, such as discount retailing, may benefit when general economic conditions weaken, as consumers become more price-conscious.
Sociocultural forces	Sociocultural forces include the societal values, attitudes, cultural factors, and lifestyles that impact businesses, as well as demographic factors such as the population size, growth rate, and age distribution. Sociocultural forces vary by locale and change over time. An example is the trend toward healthier lifestyles, which can shift spending toward exercise equipment and health clubs and away from alcohol and snack foods. Population demographics can have large implications for industries such as health care, where costs and service needs vary with demographic factors such as age and income distribution.
Technological factors	Technological factors include the pace of technological change and technical developments that have the potential for wide-ranging effects on society, such as genetic engineering and nanotechnology. They include institutions involved in creating knowledge and controlling the use of technology, such as R&D consortia, university-sponsored technology incubators, patent and copyright laws, and government control over the Internet. Technological change can encourage the birth of new industries, such as those based on nanotechnology, and disrupt others, such as the recording industry.

(continued)

TABLE 3.1 *(continued)*

Component	Description
Environmental forces	These include ecological and environmental forces such as weather, climate, climate change, and associated factors like water shortages. These factors can directly impact industries such as insurance, farming, energy production, and tourism. They may have an indirect but substantial effect on other industries such as transportation and utilities.
Legal and regulatory factors	These factors include the regulations and laws with which companies must comply such as consumer laws, labor laws, antitrust laws, and occupational health and safety regulation. Some factors, such as banking deregulation, are industry-specific. Others, such as minimum wage legislation, affect certain types of industries (low-wage, labor-intensive industries) more than others.

business situation, they still merit a watchful eye. Motor vehicle companies must adapt their strategies to customer concerns about carbon emissions and high gasoline prices. Changes in lifestyles, attitudes toward nutrition and fitness, and leisure preferences have begun to have strategy-shaping effects on companies competing in the processed food, restaurant, and fitness industries. As company managers scan the external environment, they must be alert for potentially important outer ring developments, assess their impact and influence, and adapt the company's direction and strategy as needed.

However, the factors and forces in a company's macro-environment that have the *biggest* strategy-shaping impact typically pertain to the company's immediate inner ring industry and competitive environment—competitive pressures, the actions of rival firms, buyer behavior, supplier-related considerations, and so on. Consequently, this chapter concentrates on a company's industry and competitive environment.

Assessing the Company's Industry and Competitive Environment

Thinking strategically about a company's industry and competitive environment entails using some well-validated concepts and analytical tools to get clear answers to seven questions:

1. Do the dominant economic characteristics of the industry offer sellers opportunities for growth and attractive profits?
2. What kinds of competitive forces are industry members facing, and how strong is each force?
3. What forces are driving industry change, and what impact will these changes have on competitive intensity and industry profitability?
4. What market positions do industry rivals occupy—who is strongly positioned and who is not?
5. What strategic moves are rivals likely to make next?
6. What are the key factors of competitive success?
7. Does the industry outlook offer good prospects for profitability?

Analysis-based answers to these questions are prerequisites for a strategy offering good fit with the external situation. The remainder of this chapter is devoted to describing the methods of obtaining solid answers to the seven questions above.

Question 1: What Are the Industry's Dominant Economic Characteristics?

Analyzing a company's industry and competitive environment begins with identifying the industry's dominant economic characteristics. While the general economic conditions of the macro-environment identified through PESTEL analysis may prove to be strategically relevant, it is the economic characteristics of the industry that will have a greater bearing on the industry's prospects for growth and attractive profits. An industry's dominant economic characteristics include such factors as market size and growth rate, the geographic boundaries of the market (which can extend from local to worldwide), market demand-supply conditions, market segmentation, and the pace of technological change. Table 3.2 summarizes analytical questions that define the industry's dominant economic features.

Getting a handle on an industry's distinguishing economic features not only provides a broad overview of the attractiveness of the industry, but also

TABLE 3.2

What to Consider in Identifying an Industry's Dominant Economic Features

Economic Characteristic	Questions to Answer
Market size and growth rate	• How big is the industry and how fast is it growing? • What does the industry's position in the life cycle (early development, rapid growth and takeoff, early maturity and slowing growth, saturation and stagnation, decline) reveal about the industry's growth prospects?
Scope of competitive rivalry	• Is the geographic area over which most companies compete local, regional, national, multinational, or global?
Demand-supply conditions	• Is a surplus of capacity pushing prices and profit margins down? • Is the industry overcrowded with too many competitors?
Market segmentation	• Is the industry characterized by various product characteristics or customer wants, needs, or preferences that divide the market into distinct segments?
Pace of technological change	• What role does advancing technology play in this industry? • Do most industry members have or need strong technological capabilities? Why?

promotes understanding of the kinds of strategic moves that industry members are likely to employ. For example, industries that are characterized by rapid technological change may require substantial investments in R&D and the development of strong product innovation capabilities—continuous product innovation is primarily a survival strategy in such industries as video games, computers, and pharmaceuticals.

Question 2: How Strong Are the Industry's Competitive Forces?

LO2 Recognize the factors that cause competition in an industry to be fierce, more or less normal, or relatively weak.

After gaining an understanding of the industry's general economic characteristics, industry and competitive analysis should focus on the competitive dynamics of the industry. The nature and subtleties of competitive forces are never the same from one industry to another and must be wholly understood to accurately assess the company's current situation. Far and away the most powerful and widely used tool for assessing the strength of the industry's competitive forces is the *five-forces model of competition.*[1] This model, as depicted in Figure 3.2, holds that competitive forces affecting industry attractiveness go beyond rivalry among competing sellers and include pressures stemming from four coexisting sources. The five competitive forces affecting industry attractiveness are listed below.

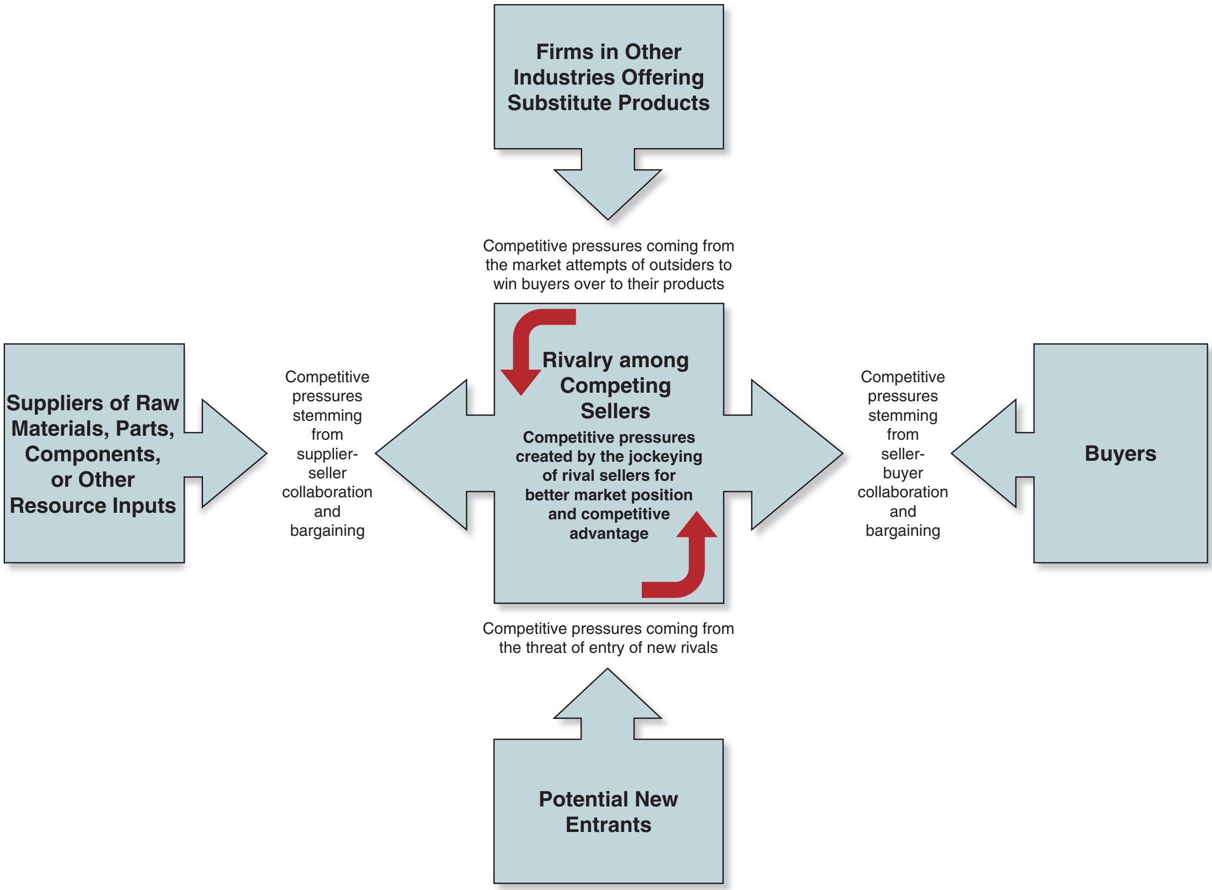
1. Competitive pressures stemming from *buyer* bargaining power.
2. Competitive pressures coming from companies in other industries to win buyers over to *substitute products.*
3. Competitive pressures stemming from *supplier* bargaining power.
4. Competitive pressures associated with the threat of *new entrants* into the market.
5. Competitive pressures associated with *rivalry among competing sellers* to attract customers. This is usually the strongest of the five competitive forces.

The Competitive Force of Buyer Bargaining Power

Whether seller-buyer relationships represent a minor or significant competitive force depends on (1) whether some or many buyers have sufficient bargaining leverage to obtain price concessions and other favorable terms, and (2) the extent to which buyers are price sensitive. Buyers with strong bargaining power can limit industry profitability by demanding price concessions, better payment terms, or additional features and services that increase industry members' costs. Buyer price sensitivity limits the profit potential of industry members by restricting the ability of sellers to raise prices without losing volume or unit sales.

The leverage that buyers have in negotiating favorable terms of the sale can range from weak to strong. Individual consumers, for example, rarely have much bargaining power in negotiating price concessions or other favorable terms with sellers. The primary exceptions involve situations in which price

FIGURE 3.2 **The Five-Forces Model of Competition**



Sources: Based on Michael E. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review* 57, no. 2 (March–April 1979), pp. 137–45; and Michael E. Porter, "The Five Competitive Forces That Shape Strategy," *Harvard Business Review* 86, no. 1 (January 2008), pp. 80–86.

haggling is customary, such as the purchase of new and used motor vehicles, homes, and other big-ticket items such as jewelry and pleasure boats. For most consumer goods and services, individual buyers have no bargaining leverage—their option is to pay the seller's posted price, delay their purchase until prices and terms improve, or take their business elsewhere.

In contrast, large retail chains such as Walmart, Best Buy, Staples, and Home Depot typically have considerable negotiating leverage in purchasing products from manufacturers because retailers usually stock just two or three competing brands of a product and rarely carry all competing brands. In addition, the strong bargaining power of major supermarket chains such as Kroger, Safeway, and Albertsons allows them 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 not only because they buy in large quantities, but also because tire makers have judged original equipment tires to be important contributors to brand awareness and brand loyalty.

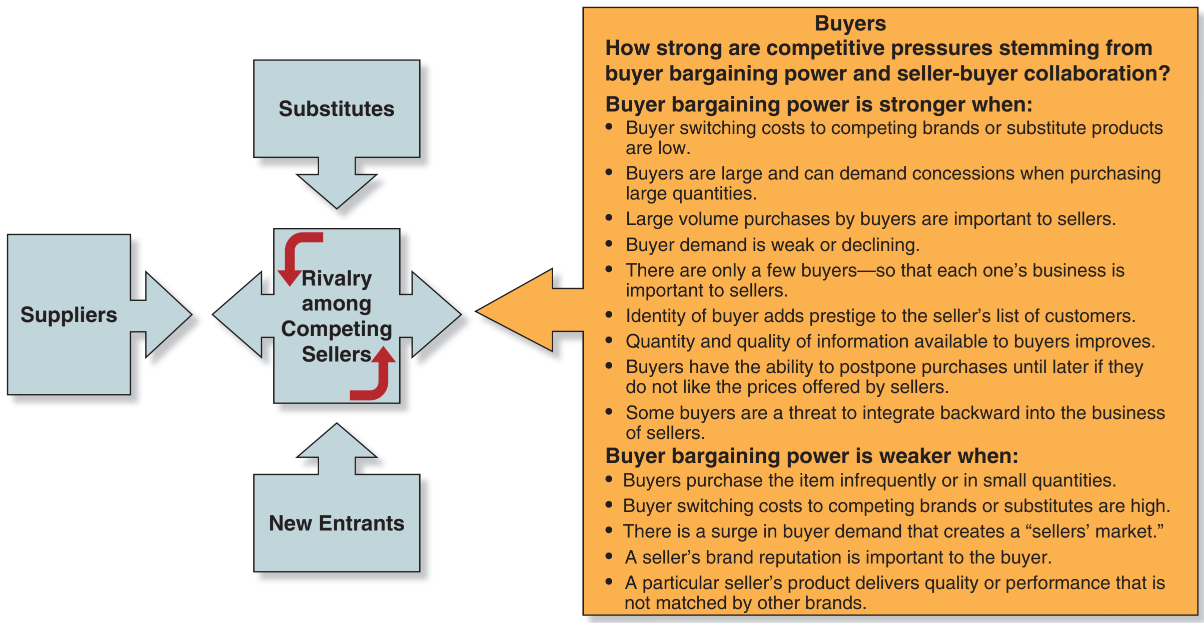
Even if buyers do not purchase in large quantities or offer a seller important market exposure or prestige, they gain a degree of bargaining leverage in the following circumstances:

- *If buyers' costs of switching to competing brands or substitutes are relatively low.* Buyers who can readily switch between several sellers have more negotiating leverage than buyers who have high switching costs. When the products of rival sellers are virtually identical, it is relatively easy for buyers to switch from seller to seller at little or no cost. For example, the screws, rivets, steel, and capacitors used in the production of large home appliances such as washers and dryers are all commodity-like and available from many sellers. The potential for buyers to easily switch from one seller to another encourages sellers to make concessions to win or retain a buyer's business.
- *If the number of buyers is small or if a customer is particularly important to a seller.* The smaller the number of buyers, the less easy it is for sellers to find alternative buyers when a customer is lost to a competitor. The prospect of losing a customer who is not easily replaced often makes a seller more willing to grant concessions of one kind or another. Because of the relatively small number of digital camera brands, the sellers of lenses and other components used in the manufacture of digital cameras are in a weak bargaining position in their negotiations with buyers of their components.
- *If buyer demand is weak.* Weak or declining demand creates a "buyers' market"; conversely, strong or rapidly growing demand creates a "sellers' market" and shifts bargaining power to sellers.
- *If buyers are well informed about sellers' products, prices, and costs.* The more information buyers have, the better bargaining position they are in. The mushrooming availability of product information on the Internet is giving added bargaining power to individuals. It has become common for automobile shoppers to arrive at dealerships armed with invoice prices, dealer holdback information, a summary of incentives, and manufacturers' financing terms.
- *If buyers pose a credible threat of integrating backward into the business of sellers.* Companies such as Anheuser-Busch, Coors, and Heinz have integrated backward into metal can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerful metal can manufacturers.

Figure 3.3 summarizes factors causing buyer bargaining power to be strong or weak.

Not all buyers of an industry's product have equal degrees of bargaining power with sellers, and some may be less sensitive than others to price, quality, or service differences. For example, apparel manufacturers confront significant bargaining power when selling to big retailers such as Macy's, T. J. Maxx, or Target, but they can command much better prices selling to small owner-managed apparel boutiques.

FIGURE 3.3 **Factors Affecting the Strength of Buyer Bargaining Power**



The Competitive Force of Substitute Products

Companies in one industry are vulnerable to competitive pressure from the actions of companies in another industry whenever buyers view the products of the two industries as good substitutes. For instance, the producers of sugar experience competitive pressures from the sales and marketing efforts of the makers of Equal, Splenda, and Sweet'N Low. Newspapers are struggling to maintain their relevance to subscribers who can watch the news on numerous television channels or go to the Internet for updates, blogs, and articles. Similarly, the producers of eyeglasses and contact lenses face competitive pressures from doctors who do corrective laser surgery.

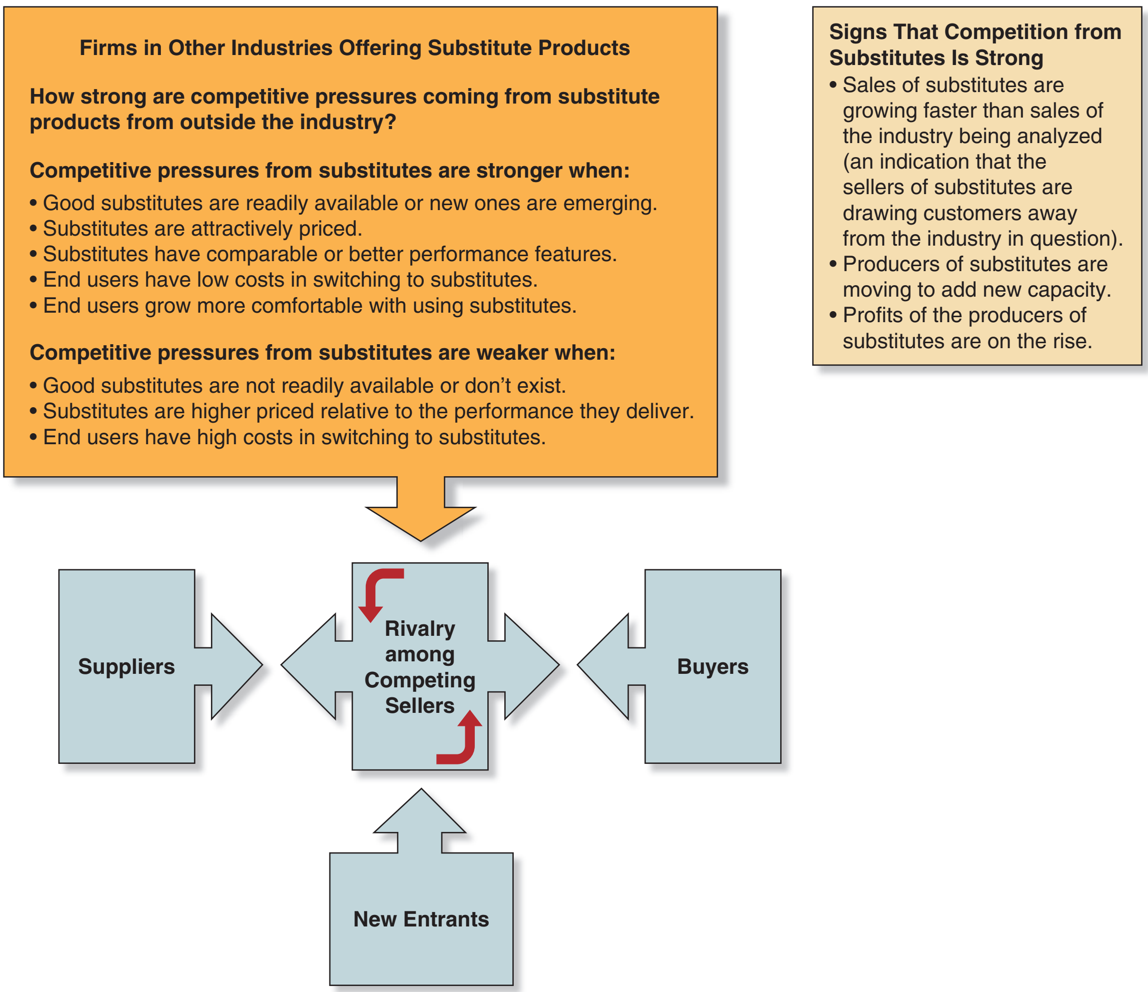
Just how strong the competitive pressures are from the sellers of substitute products depends on three factors:

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. When substitutes are cheaper than an industry's product, industry members come under heavy competitive pressure to reduce their prices and find ways to absorb the price cuts with cost reductions.
2. *Whether buyers view the substitutes as comparable or better in terms of quality, performance, and other relevant attributes.* Customers are prone to compare performance and other attributes as well as price. For example, consumers have found digital cameras to be a superior substitute to film cameras because of the superior ease of use, the ability to download images to a home computer, and the ability to delete bad shots without paying for film developing.

3. *Whether the costs that buyers incur in switching to the substitutes are high or low.* High switching costs deter switching to substitutes while low switching costs make it easier for the sellers of attractive substitutes to lure buyers to their products. Typical switching costs include the inconvenience of switching to a substitute, the costs of additional equipment, the psychological costs of severing old supplier relationships, and employee retraining costs.

Figure 3.4 summarizes the conditions that determine whether the competitive pressures from substitute products are strong, moderate, or weak. As a rule, the lower the price of substitutes, the higher their quality and performance, and the lower the user's switching costs, the more intense the competitive pressures posed by substitute products.

FIGURE 3.4 **Factors Affecting Competition from Substitute Products**



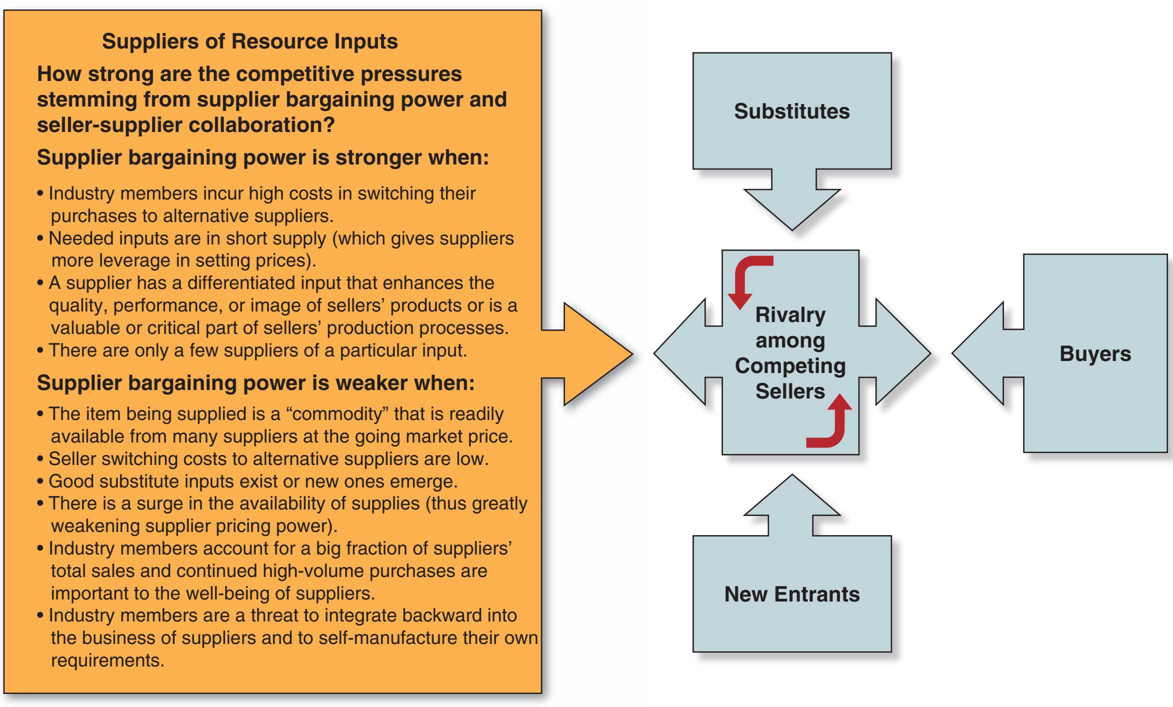
The Competitive Force of Supplier Bargaining Power

Whether the suppliers of industry members represent a weak or strong competitive force depends on the degree to which suppliers have sufficient *bargaining power* to influence the terms and conditions of supply in their favor. Suppliers with strong bargaining power can erode industry profitability by charging industry members higher prices, passing costs on to them, and limiting their opportunities to find better deals. For instance, Microsoft and Intel, both of which supply PC makers with essential components, have been known to use their dominant market status not only to charge PC makers premium prices but also to leverage PC makers in other ways. The bargaining power possessed by Microsoft and Intel when negotiating with customers is so great that both companies have faced antitrust charges on numerous occasions. Before a legal agreement ending the practice, Microsoft pressured PC makers to load only Microsoft products on the PCs they shipped. Intel has also defended against antitrust charges resulting from its bargaining strength, but continues to give PC makers that use the biggest percentages of Intel chips in their PC models top priority in filling orders for newly introduced Intel chips. Being on Intel's list of preferred customers helps a PC maker get an early allocation of Intel's latest chips and thus allows a PC maker to get new models to market ahead of rivals.

The factors that determine whether any of the industry suppliers are in a position to exert substantial bargaining power or leverage are fairly clear-cut:

- *If the item being supplied is a commodity that is readily available from many suppliers.* Suppliers have little or no bargaining power or leverage whenever industry members have the ability to source from any of several alternative and eager suppliers.
- *The ability of industry members to switch their purchases from one supplier to another or to switch to attractive substitutes.* High switching costs increase supplier bargaining power, whereas low switching costs and the ready availability of good substitute inputs weaken supplier bargaining power.
- *If certain inputs are in short supply.* Suppliers of items in short supply have some degree of pricing power.
- *If certain suppliers provide a differentiated input that enhances the performance, quality, or image of the industry's product.* The greater the ability of a particular input to enhance a product's performance, quality, or image, the more bargaining leverage its suppliers are likely to possess.
- *Whether certain suppliers provide equipment or services that deliver cost savings to industry members in conducting their operations.* Suppliers who provide cost-saving equipment or services are likely to possess some degree of bargaining leverage.
- *The fraction of the costs of the industry's product accounted for by the cost of a particular input.* The bigger the cost of a specific part or component, the more opportunity for competition in the marketplace to be affected by the actions of suppliers to raise or lower their prices.
- *If industry members are major customers of suppliers.* As a rule, suppliers have less bargaining leverage when their sales to members of this one industry

FIGURE 3.5 **Factors Affecting the Strength of Supplier Bargaining Power**



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.

- *Whether it makes good economic sense for industry members to vertically integrate backward.* The make-or-buy decision generally boils down to whether suppliers are able to supply a particular component at a lower cost than industry members could achieve if they were to integrate backward.

Figure 3.5 summarizes the conditions that tend to make supplier bargaining power strong or weak.

The Competitive Force of Potential New Entrants

Several factors determine whether the threat of new companies entering the marketplace presents a significant competitive pressure. One factor relates to the size of the pool of likely entry candidates and the 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 of the likely entry candidates have ample resources to support entry into a new line of business. Frequently, the strongest competitive pressures associated with potential entry come not from outsiders but from current industry participants looking for growth opportunities. *Existing industry members are often strong candidates to enter market segments or geographic areas where they currently do not have a market presence.*

A second factor concerns whether the likely entry candidates face high or low entry barriers. High barriers reduce the competitive threat of potential entry, while low barriers make entry more likely, especially if the industry is growing and offers attractive profit opportunities. The most widely encountered barriers that entry candidates must hurdle include:[2]

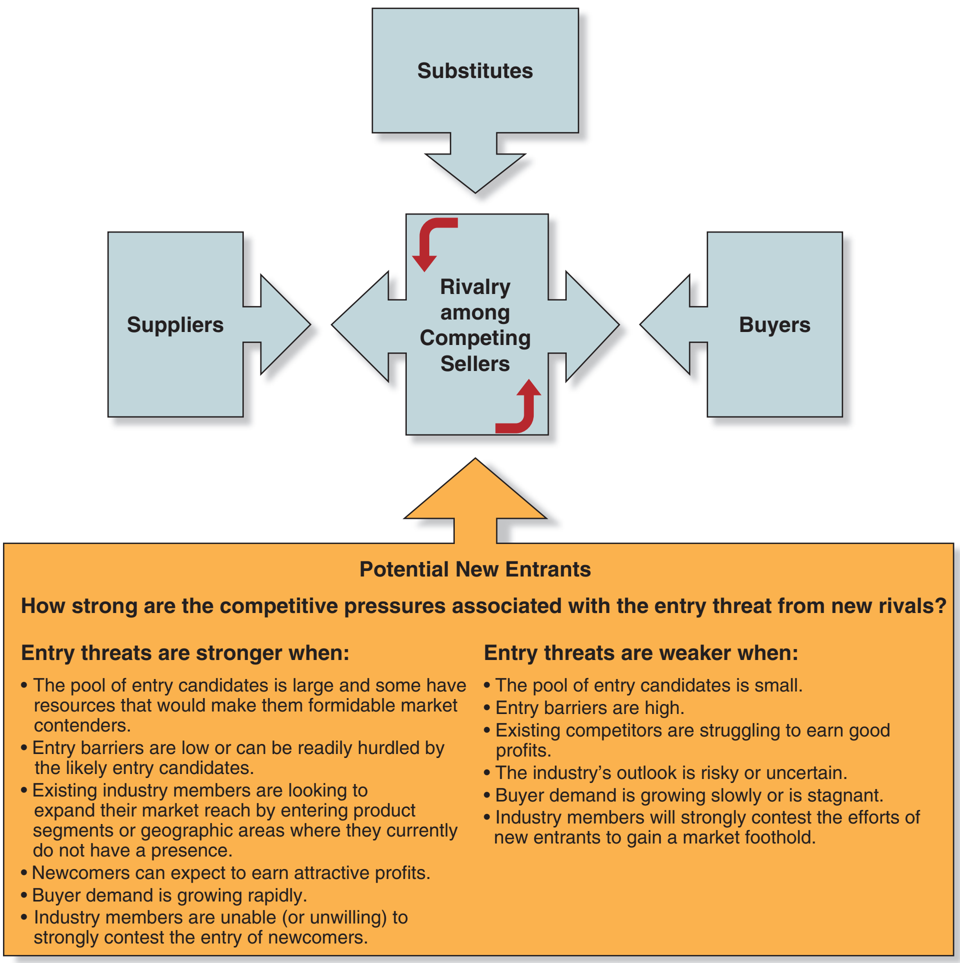
- *The presence of sizable economies of scale in production or other areas of operation.* When incumbent companies enjoy cost advantages associated with large-scale operations, outsiders must either enter on a large scale (a costly and perhaps risky move) or accept a cost disadvantage and consequently lower profitability.
- *Cost and resource disadvantages not related to scale of operation.* Aside from enjoying economies of scale, industry incumbents can have cost advantages that stem from the possession of proprietary technology, partnerships with the best and cheapest suppliers, low fixed costs (because they have older facilities that have been mostly depreciated), and experience/learning curve effects. The microprocessor industry is an excellent example of how learning/experience curves put new entrants at a substantial cost disadvantage. Manufacturing unit costs for microprocessors tend to decline about 20 percent each time *cumulative* production volume doubles. With a 20 percent experience curve effect, if the first 1 million chips cost $100 each, once production volume reaches 2 million the unit cost would fall to $80 (80 percent of $100), and by a production volume of 4 million the unit cost would be $64 (80 percent of $80).[3] The bigger the learning or experience curve effect, the bigger the cost advantage of the company with the largest *cumulative* production volume.
- *Strong brand preferences and high degrees of customer loyalty.* The stronger the attachment of buyers to established brands, the harder it is for a newcomer to break into the marketplace.
- *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 start-up costs.
- *The difficulties of building a network of distributors-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. Retailers have to be recruited and convinced to give a new brand ample display space and an adequate trial period. 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.
- *Restrictive regulatory policies.* Government agencies can limit or even bar entry by requiring licenses and permits. Regulated industries such as cable TV, telecommunications, electric and gas utilities, and radio and television broadcasting entail government-controlled entry.
- *Tariffs and international trade restrictions.* National governments commonly use tariffs and trade restrictions (antidumping rules, local content requirements,

local ownership requirements, quotas, etc.) to raise entry barriers for foreign firms and protect domestic producers from outside competition.

- *The ability and willingness of industry incumbents to launch vigorous initiatives to block a newcomer's successful entry.* Even if a potential entrant has or can acquire the needed competencies and resources to attempt entry, it must still worry about the reaction of existing firms.[4] Sometimes, there's little that incumbents can do to throw obstacles in an entrant's path. But there are times when incumbents use price cuts, increase advertising, introduce product improvements, and launch legal attacks to prevent the entrant from building a clientele. Cable TV companies have vigorously fought the entry of satellite TV into the industry by seeking government intervention to delay satellite providers in offering local stations, offering satellite customers discounts to switch back to cable, and charging satellite customers high monthly rates for cable Internet access.

Figure 3.6 summarizes conditions making the threat of entry strong or weak.

FIGURE 3.6 Factors Affecting the Threat of Entry



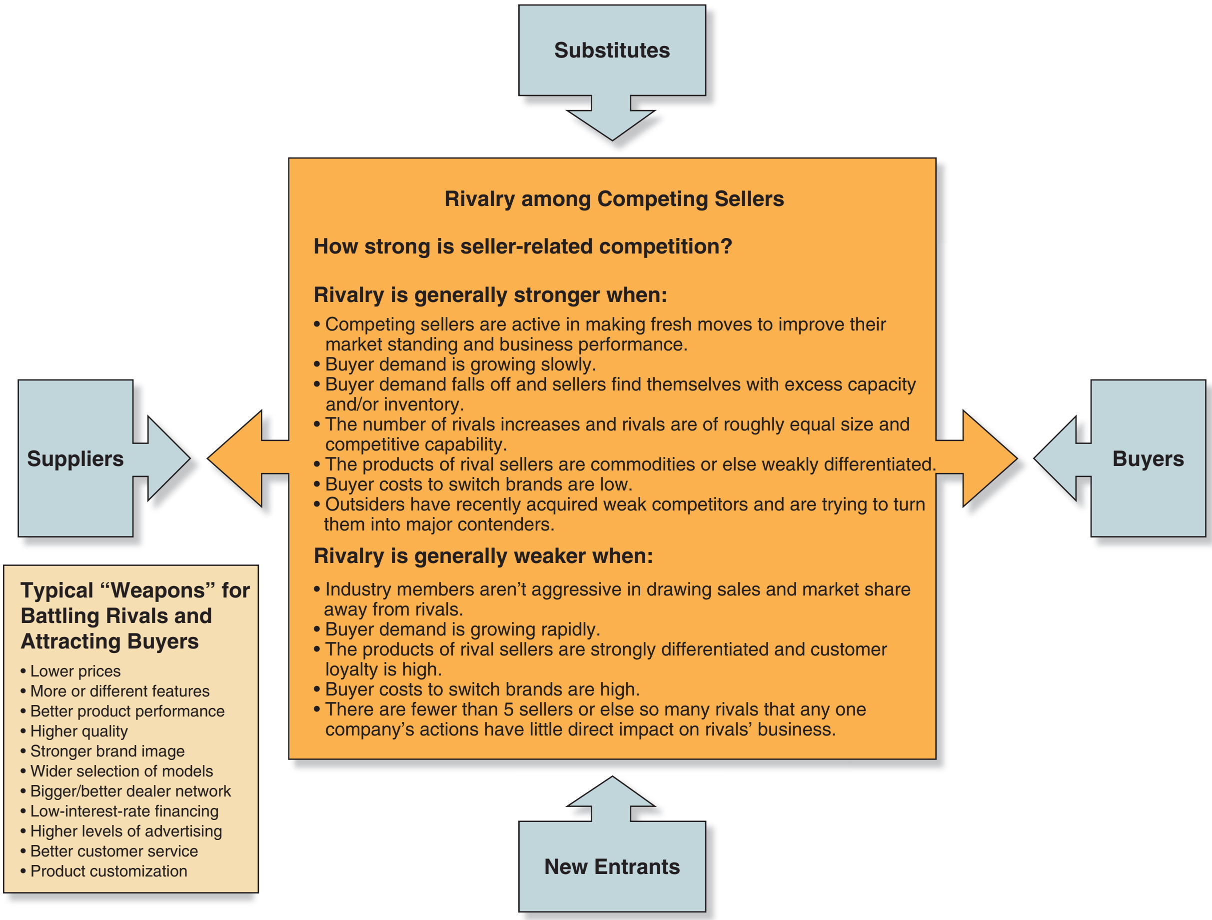
The Competitive Force of Rivalry among Competing Sellers

The strongest of the five competitive forces is nearly always the rivalry among competing sellers of a product or service. In effect, *a market is a competitive battlefield* where there's no end to the campaign for buyer patronage. Rival sellers are prone to employ whatever weapons they have in their business arsenal to improve their market positions, strengthen their market position with buyers, and earn good profits. The strategy formulation 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 rivals.* But competitive contests are ongoing and dynamic. When one firm makes a strategic move that produces good results, its rivals typically respond with offensive or defensive countermoves of their own. This pattern of action and reaction produces a continually evolving competitive landscape where the market battle ebbs and flows and produces winners and losers. But the current market leaders have no guarantees of continued leadership. In every industry, the ongoing jockeying of rivals leads to one or more companies gaining or losing momentum in the marketplace according to whether their latest strategic maneuvers succeed or fail.[5]

Figure 3.7 shows a sampling of competitive weapons that firms can deploy in battling rivals and indicates the factors that influence the intensity of their rivalry. Some factors that influence the tempo of rivalry among industry competitors include:

- *Rivalry intensifies when competing sellers regularly launch fresh actions to boost their market standing and business performance.* Normally, competitive jockeying among rival sellers is fairly intense. Indicators of strong competitive rivalry include lively price competition, the rapid introduction of next-generation products, and moves to differentiate products by offering better performance features, higher quality, improved customer service, or a wider product selection. Other common tactics used to temporarily boost sales include special sales promotions, heavy advertising, rebates, or low-interest-rate financing.
- *Rivalry is stronger in industries where competitors are equal in size and capability.* Competitive rivalry in the quick-service restaurant industry is particularly strong where there are numerous relatively equal-sized hamburger, deli sandwich, chicken, and taco chains. For the most part, McDonald's, Burger King, Taco Bell, KFC, Arby's, and other national fast-food chains have comparable capabilities and are required to compete aggressively to hold their own in the industry.
- *Rivalry is usually stronger in slow-growing markets and weaker in fast-growing markets.* Rapidly expanding buyer demand produces enough new business for all industry members to grow. But in markets where growth is sluggish or where buyer demand drops off unexpectedly, it is not uncommon for competitive rivalry to intensify significantly as rivals battle for market share and volume gains.
- *Rivalry is usually weaker in industries comprised of vast numbers of small rivals; likewise, it is often weak when there are fewer than five competitors.*

FIGURE 3.7 **Factors Affecting the Strength of Competitive Rivalry**



Head-to-head rivalry tends to be weak once an industry becomes populated with so many rivals that the strategic moves of any one competitor have little discernible impact on the success of rivals. Rivalry also *tends* to be weak if an industry consists of just two to four sellers. In a market with few rivals, each competitor soon learns that aggressive moves to grow its sales and market share can have an immediate adverse impact on rivals' businesses, almost certainly provoking vigorous retaliation. However, some caution must be exercised in concluding that rivalry is weak just because there are only a few competitors. The fierceness of the current battle between Google and Microsoft and the decades-long war between Coca-Cola and Pepsi are prime examples.

- *Rivalry increases when buyer demand falls off and sellers find themselves with excess capacity and/or inventory.* Excess supply conditions create a "buyers' market," putting added competitive pressure on industry rivals to scramble for profitable sales levels (often by price discounting).

- *Rivalry increases as it becomes less costly for buyers to switch brands.* The less expensive 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.
- *Rivalry increases as the products of rival sellers become more standardized and diminishes as the products of industry rivals become more differentiated.* When the offerings of rivals are identical or weakly differentiated, buyers have less reason to be brand loyal—a condition that makes it easier for rivals to persuade buyers to switch to their offering. On the other hand, strongly differentiated product offerings among rivals breed high brand loyalty on the part of buyers.
- *Rivalry is more intense when industry conditions tempt competitors to use price cuts or other competitive weapons to boost unit volume.* When a product is perishable, seasonal, or costly to hold in inventory, competitive pressures build quickly any time one or more firms decide to cut prices and dump supplies on the market. Likewise, whenever fixed costs account for a large fraction of total cost, so that unit costs tend to be lowest at or near full capacity, firms come under significant pressure to cut prices or otherwise try to boost sales whenever they are operating below full capacity.
- *Rivalry increases when one or more competitors become dissatisfied with their market position.* Firms that are losing ground or are in financial trouble often pursue aggressive (or perhaps desperate) turnaround strategies that can involve price discounts, greater advertising, or merger with other rivals. Such strategies can turn competitive pressures up a notch.
- *Rivalry increases when strong companies outside the industry acquire weak firms in the industry and launch aggressive, well-funded moves to build market share.* A concerted effort to turn a weak rival into a market leader 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—actions that, if successful, put added pressure on rivals to counter with fresh strategic moves of their own.

Rivalry can be characterized as *cutthroat* or *brutal* when competitors engage in protracted price wars or habitually employ other aggressive tactics that are mutually destructive to profitability. Rivalry can be considered *fierce* to *strong* when the battle for market share is so vigorous that the profit margins of most industry members are squeezed to bare-bones levels. Rivalry can be characterized as *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 share and rarely undertake offensives to steal customers away from one another.

The Collective Strengths of the Five Competitive Forces and Industry Profitability

Scrutinizing each of the five competitive forces one by one provides a powerful diagnosis of what competition is like in a given market. Once the strategist has gained an understanding of the competitive pressures associated with each of the five forces, the next step is to evaluate the collective strength of the five forces and determine if companies in this industry should reasonably expect to earn decent 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 is 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 customers 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. Fierce competitive pressures from just one of the five forces, such as brutal price competition among rival sellers, may suffice to destroy the conditions for good profitability.

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

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 companies with mediocre strategies and second-rate implementation because even they can expect a decent profit.

Question 3: What Are the Industry's Driving Forces of Change and What Impact Will They Have?

The intensity of competitive forces and the level of industry attractiveness are almost always fluid and subject to change. It is essential for strategy makers to understand the current competitive dynamics of the industry, but it is equally important for strategy makers to consider how the industry is changing and the effect of industry changes that are under way. Any strategies devised by management will play out in a dynamic industry environment, so it's imperative that such plans consider what the industry environment might look like during the near term.

The Concept of Industry Driving Forces

Industry and competitive conditions change because forces are enticing or pressuring certain industry participants (competitors, customers, suppliers) to alter their actions in important ways. 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 3.1), but most originate in the company's more immediate industry and competitive environment.

CORE CONCEPT

Driving forces are the major underlying causes of change in industry and competitive conditions.

Driving forces analysis has three steps: (1) identifying what the driving forces are, (2) assessing whether the drivers of change are, individually or collectively, acting to make the industry more or less attractive, and (3) determining what strategy changes are needed to prepare for the impact of the driving forces.

Identifying an Industry's Driving Forces

Many developments can affect an industry powerfully enough to qualify as driving forces, but most drivers of industry and competitive change fall into one of the following categories:

- *Changes in an industry's long-term growth rate.* Shifts in industry growth have the potential to affect the balance between industry supply and buyer demand, entry and exit, and the character and strength of competition. An upsurge in buyer demand triggers a race among established firms and newcomers to capture the new sales opportunities. A slowdown in the growth of demand nearly always brings an increase in rivalry and increased efforts by some firms to maintain their high rates of growth by taking sales and market share away from rivals.
- *Increasing globalization.* Competition begins to shift from primarily a regional or national focus to an international or global focus when industry members begin seeking customers in foreign markets or when production activities begin to migrate to countries where costs are lowest. 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 such industries as credit cards, mobile phones, digital cameras, motor vehicles, steel, petroleum, personal computers, and video games.
- *Changes in who buys the product and how they use it.* Shifts in buyer demographics and the ways products are used can alter competition by affecting how customers perceive value, how customers make purchasing decisions, and where customers purchase the product. The burgeoning popularity of streaming video has affected broadband providers, wireless phone carriers, and television broadcasters and created opportunities for such new entertainment businesses as Hulu and Netflix.
- *Product innovation.* 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 computers, digital cameras, televisions, video games, and prescription drugs.

- *Technological change and manufacturing process innovation.* Advances in technology can dramatically alter an industry's landscape, making it possible to produce new and better products at lower cost and opening new industry frontiers. For instance, Voice over Internet Protocol technology (VoIP) has spawned low-cost, Internet-based phone networks that have begun competing with traditional telephone companies worldwide (whose higher-cost technology depends on hard-wire connections via overhead and underground telephone lines).
- *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.
- *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 start-up venture, it usually pushes competition in new directions.
- *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 can occur through scientific journals, trade publications, on-site plant tours, word of mouth among suppliers and customers, employee migration, and Internet sources.
- *Changes in cost and efficiency.* Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. Declining costs to produce PCs have enabled price cuts and spurred PC sales (especially lower-priced models) by making them more affordable to lower-income households worldwide.
- *Growing buyer preferences for differentiated products instead of a commodity product (or for a more standardized product instead of strongly differentiated products).* When a shift from standardized to differentiated products occurs, rivals must adopt strategies to outdifferentiate one another. However, buyers sometimes decide that a standardized, budget-priced product suits their requirements as well as a premium-priced product with lots of snappy features and personalized services.
- *Regulatory influences and government policy changes.* Government regulatory actions can often force significant changes in industry practices and strategic approaches. New rules and regulations pertaining to government-sponsored health insurance programs are driving changes in the health care industry. In international markets, host governments can drive competitive changes by opening their domestic markets to foreign participation or closing them.

TABLE 3.3

Common Driving Forces

1. Changes in the long-term industry growth rate.
2. Increasing globalization.
3. Emerging new Internet capabilities and applications.
4. Changes in who buys the product and how they use it.
5. Product innovation.
6. Technological change and manufacturing process innovation.
7. Marketing innovation.
8. Entry or exit of major firms.
9. Diffusion of technical know-how across more companies and more countries.
10. Changes in cost and efficiency.
11. Growing buyer preferences for differentiated products instead of a standardized commodity product (or for a more standardized product instead of strongly differentiated products).
12. Regulatory influences and government policy changes.
13. Changing societal concerns, attitudes, and lifestyles.

- *Changing societal concerns, attitudes, and lifestyles.* Emerging social issues and changing attitudes and lifestyles can be powerful instigators of industry change. Consumer concerns about the use of chemical additives and the nutritional content of food products have forced food producers to revamp food-processing techniques, redirect R&D efforts into the use of healthier ingredients, and compete in developing nutritious, good-tasting products.

While many forces of change may be at work in a given industry, *no more than three or four* are likely to be true driving forces powerful enough to qualify as the *major determinants* of why and how the industry is changing. Thus, company strategists must resist the temptation to label every change they see as a driving force. Table 3.3 lists the most common driving forces.

Assessing the Impact of the Industry Driving Forces

The second step in driving forces analysis is to determine whether the prevailing driving forces are acting to make the industry environment more or less attractive. Getting a handle on the collective impact of the driving forces usually requires looking at the likely effects of each force separately, because the driving forces may not all be pushing change in the same direction. For example, two driving forces may be acting to spur demand for the industry's product while one driving force may be working to curtail demand. Whether the net effect on industry demand is up or down hinges on which driving forces are the more powerful.

> An important part of driving forces analysis is to determine whether the individual or 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.

Determining Strategy Changes Needed to Prepare for the Impact 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

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.

strategy adjustments will be needed to deal with the impact of the driving forces. Without understanding the forces driving industry change and the impacts these forces will have on the industry environment over the next one to three years, managers are ill prepared to craft a strategy tightly matched to emerging conditions. Similarly, if managers are uncertain about the implications of one or more driving forces, or if their views are off-base, it will be difficult for them to craft a strategy that is responsive to the consequences of driving forces. So driving forces analysis is not something to take lightly; it has practical value and is basic to the task of thinking strategically about where the industry is headed and how to prepare for the changes ahead.

Question 4: How Are Industry Rivals Positioned?

LO3 Become adept at mapping the market positions of key groups of industry rivals.

The nature of competitive strategy inherently positions companies competing in an industry into strategic groups with diverse price/quality ranges, different distribution channels, varying product features, and different geographic coverages. The best technique for revealing the market positions of industry competitors is **strategic group mapping.** This analytical tool is useful for comparing the market positions of industry competitors or for grouping industry combatants into like positions.

CORE CONCEPT

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

Using Strategic Group Maps to Assess the Positioning of Key Competitors

A **strategic group** consists of those industry members with similar competitive approaches and positions in the market. 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, or offer buyers similar services and technical assistance.[6] An industry with a commodity-like product may contain only one strategic group whereby all sellers pursue essentially identical strategies and have comparable market positions. But even with commodity products, there is likely some attempt at differentiation occurring in the form of varying delivery times, financing terms, or levels of customer service. Most industries offer a host of competitive approaches that allow companies to find unique industry positioning and avoid fierce competition in a crowded strategic group. Evaluating strategy options entails examining what strategic groups exist, identifying which companies exist within each group, and determining if a

CORE CONCEPT

A **strategic group** is a cluster of industry rivals that have similar competitive approaches and market positions.

competitive "white space" exists where industry competitors are able to create and capture altogether new demand.

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

- Identify the competitive characteristics that delineate strategic approaches used in the industry. Typical variables used in creating strategic group maps are the price/quality range (high, medium, low), geographic coverage (local, regional, national, global), degree of vertical integration (none, partial, full), product-line breadth (wide, narrow), choice of distribution channels (retail, wholesale, Internet, multiple channels), and degree of service offered (no-frills, limited, full).
- Plot firms on a two-variable map based upon their strategic approaches.
- Assign firms occupying the same map location to a common 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 for the retail chain store industry in Concepts & Connections 3.1.

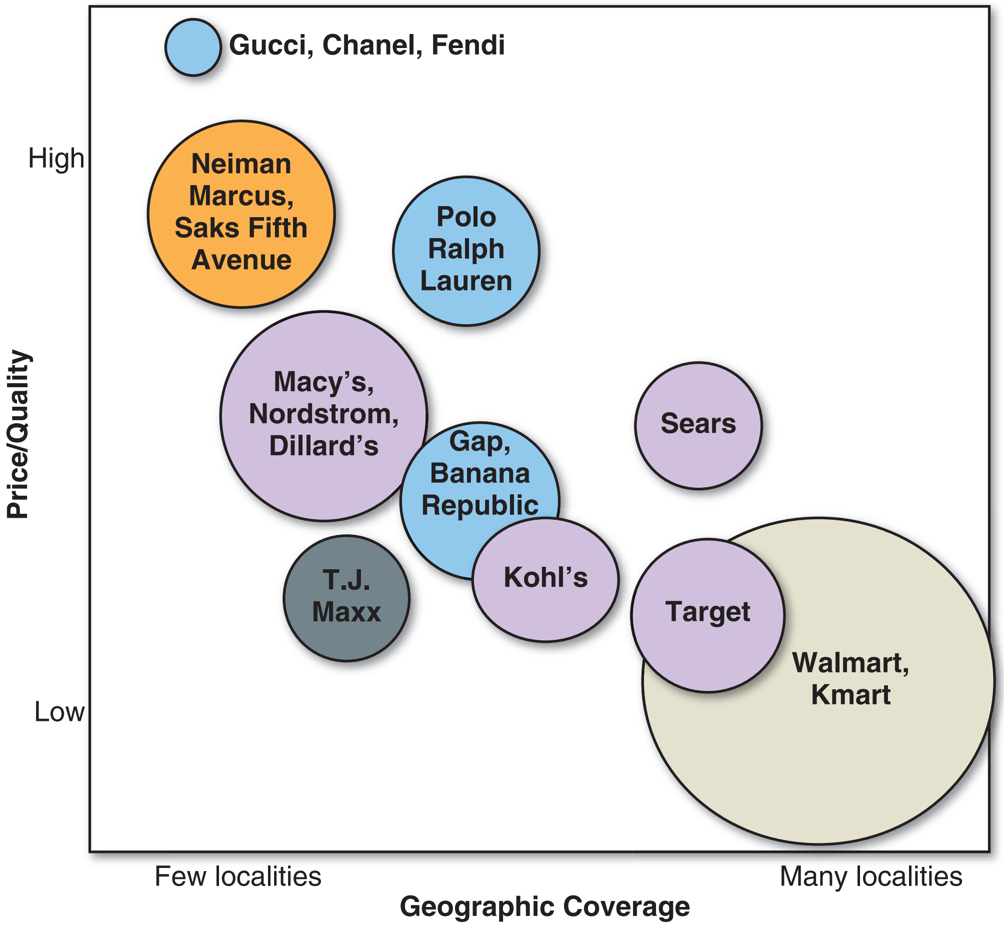
Several guidelines need to be observed in creating strategic group maps. First, the two variables selected as axes for the map should *not* be highly correlated; if they are, the circles on the map will fall along a diagonal and strategy makers will learn nothing more about the relative positions of competitors than they would by considering 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 product line-breadth reveals just as much about industry positioning as looking at the two competitive variables. Second, the variables chosen as axes for the map should reflect key approaches to offering value to customers and expose big differences in how rivals position themselves in the marketplace. Third, the variables used as axes don't have to be either quantitative or continuous; rather, they can be discrete variables or defined in terms of distinct classes and combinations. 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 sizes of each strategic group. Fifth, if more than two good competitive variables can be used as axes for the map, multiple maps can be drawn to give different exposures to the competitive positioning in the industry. Because there is not necessarily one best map for portraying how competing firms are positioned in the market, it is advisable to experiment with different pairs of competitive variables.

The Value of Strategic Group Maps

Strategic group maps are revealing in several respects. The *most important* has to do with identifying which rivals are similarly positioned and are thus close rivals and which are distant rivals. Generally, *the closer strategic groups are to each other on the map, the stronger the cross-group competitive rivalry tends to be.* Although firms in the same strategic group are the closest rivals, the next closest rivals are in the immediately adjacent groups.[7] Often, firms in strategic groups

CONCEPTS & CONNECTIONS 3.1

COMPARATIVE MARKET POSITIONS OF SELECTED RETAIL CHAINS: A STRATEGIC GROUP MAP APPLICATION



Note: Circles are drawn roughly proportional to the total revenues of the retail chains included in each strategic group.

> Some strategic groups are more favorably positioned than others because they confront weaker competitive forces and/or because they are more favorably impacted by industry driving forces.

that are far apart on the map hardly compete. For instance, Walmart's clientele, merchandise selection, and pricing points are much too different to justify calling them close competitors of Neiman Marcus or Saks Fifth Avenue in retailing. For the same reason, Timex is not a meaningful competitive rival of Rolex, and Kia is not a close competitor of Porsche or Lexus.

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

1. *Industry driving forces may favor some strategic groups and hurt others.* Driving forces in an industry may be acting to grow the demand for the products of firms in some strategic groups and shrink the demand for the products of firms in other strategic groups—as is the case in the news industry where Internet news services and cable news networks are gaining ground at the expense of newspapers and network television. The industry driving forces of emerging Internet capabilities and applications, changes in who buys the product and how they use it, and changing societal concerns, attitudes, and lifestyles are making it increasingly difficult for traditional media to increase audiences and attract new advertisers.
2. *Competitive pressures may cause the profit potential of different strategic groups to vary.* The profit prospects of firms in different strategic groups can vary from good to poor because of differing degrees of competitive rivalry within strategic groups, differing degrees of exposure to competition from substitute products outside the industry, and differing degrees of supplier or customer bargaining power from group to group. For instance, the competitive battle between Walmart and Target is more intense (with consequently smaller profit margins) than the rivalry among Versace, Chanel, Fendi, and other high-end fashion retailers.

Thus, part of strategic group analysis always entails drawing conclusions about where on the map is the "best" place to be and why. Which companies or strategic groups are in the best positions to prosper and which might be expected to struggle? And equally important, how might firms in poorly positioned strategic groups reposition themselves to improve their prospects for good financial performance?

Question 5: What Strategic Moves Are Rivals Likely to Make Next?

As in sports, scouting the business opposition is an essential part of game plan development. **Competitive intelligence** about rivals' strategies, their latest actions and announcements, their resources and organizational capabilities, and the thinking and leadership styles of their executives is valuable for predicting the strategic moves competitors are likely to make next. Having good information to predict the likely moves of key competitors allows a company to prepare defensive countermoves and to exploit any openings that arise from competitors' missteps.

Considerations in trying to predict what strategic moves rivals are likely to make next include the following:

- What executives are saying about where the industry is headed, the firm's situation, and their past actions and leadership styles.
- Identifying trends in the timing of product launches or new marketing promotions.
- Determining which rivals badly need to increase unit sales and market share.
- Considering which rivals have a strong incentive, along with the resources, to make major strategic changes.

CONCEPTS & CONNECTIONS 3.2

BUSINESS ETHICS AND COMPETITIVE INTELLIGENCE

Those who gather competitive intelligence on rivals can sometimes cross the fine line between honest inquiry and unethical or even illegal behavior. For example, calling rivals to get information about prices, the dates of new-product introductions, or wage and salary levels is legal, but misrepresenting one's company affiliation during such calls is unethical. Pumping rivals' representatives at trade shows is ethical only if one wears a name tag with accurate company affiliation indicated. Avon Products at one point secured information about its biggest rival, Mary Kay Cosmetics (MKC), by having its personnel search through the garbage bins outside MKC's headquarters.[8] When MKC officials learned of the action and sued, Avon claimed it did nothing illegal because a 1988 Supreme Court ruling declared that trash left on public property (in this case, a sidewalk) was anyone's for the taking. Avon even produced a videotape of its removal of the trash at the MKC site. Avon won the lawsuit—but Avon's action, while legal, scarcely qualifies as ethical.

- Knowing which rivals are likely to enter new geographic markets.
- Deciding which rivals are strong candidates to expand their product offerings and enter new product segments.

To succeed in predicting a competitor's next moves, company strategists need to have a good understanding of each rival's situation, its pattern of behavior and preferences in responding to prior strategic attacks, what its best strategic options are, and how rival management measures success. 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 and to take rivals' probable actions into account in crafting their own offensive strategies.[9] Concepts & Connections 3.2 discusses the ethical limits to gathering competitive intelligence.

Studying competitors' past behavior and preferences provides a valuable assist in anticipating what moves rivals are likely to make next and outmaneuvering them in the marketplace.

Question 6: What Are the Industry Key Success Factors?

An industry's **key success factors (KSFs)** are those competitive factors that most affect industry members' ability to prosper in the marketplace. Key success factors may include particular strategy elements, product attributes, resources, competitive capabilities, or intangible assets. 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 an eventual exit from the industry.

CORE CONCEPT

Key success factors are the strategy elements, product attributes, competitive capabilities, or intangible assets with the greatest impact on future success in the marketplace.

In the ready-to-wear apparel industry, the KSFs are appealing designs and color combinations, low-cost manufacturing, a strong network of retailers or company-owned stores, distribution capabilities that allow stores to keep the best-selling items in stock, and advertisements that effectively convey the brand's image. These attributes and capabilities apply to all brands of apparel ranging from private-label brands sold by discounters to premium-priced ready-to-wear brands sold by upscale department stores. Table 3.4 lists the most common types of industry key success factors.

TABLE 3.4

Common Types of Industry Key Success Factors

Technology-related KSFs	• Expertise in a particular technology or in scientific research (important in pharmaceuticals, Internet applications, mobile communications, and most high-tech industries) • Proven ability to improve production processes (important in industries where advancing technology opens the way for higher manufacturing efficiency and lower production costs)
Manufacturing-related KSFs	• Ability to achieve scale economies and/or capture experience curve effects (important to achieving low production costs) • Quality control know-how (important in industries where customers insist on product reliability) • High utilization of fixed assets (important in capital-intensive/high-fixed-cost industries) • Access to attractive supplies of skilled labor • High labor productivity (important for items with high labor content) • Low-cost product design and engineering (reduces manufacturing costs) • Ability to manufacture or assemble products that are customized to buyer specifications
Distribution-related KSFs	• A strong network of wholesale distributors/dealers • Strong direct sales capabilities via the Internet and/or having company-owned retail outlets • Ability to secure favorable display space on retailer shelves
Marketing-related KSFs	• Breadth of product line and product selection • A well-known and well-respected brand name • Fast, accurate technical assistance • Courteous, personalized customer service • Accurate filling of buyer orders (few back orders or mistakes) • Customer guarantees and warranties (important in mail-order and online retailing, big-ticket purchases, and new-product introductions) • Clever advertising
Skills- and capability-related KSFs	• A talented workforce (superior talent is important in professional services such as accounting and investment banking) • National or global distribution capabilities • Product innovation capabilities (important in industries where rivals are racing to be first to market with new product attributes or performance features) • Design expertise (important in fashion and apparel industries) • Short delivery time capability • Supply chain management capabilities • Strong e-commerce capabilities—a user-friendly website and/or skills in using Internet technology applications to streamline internal operations
Other types of KSFs	• Overall low costs (not just in manufacturing) to be able to meet low-price expectations of customers • Convenient locations (important in many retailing businesses) • Ability to provide fast, convenient, after-the-sale repairs and service • A strong balance sheet and access to financial capital (important in newly emerging industries with high degrees of business risk and in capital-intensive industries) • Patent protection

An industry's key success factors can usually be deduced through identifying the industry's dominant characteristics, assessing the five competitive forces, considering the impacts of the driving forces, comparing the market positions of industry members, and forecasting the likely next moves of key rivals. In addition, the answers to the following three questions help identify an industry's key success factors:

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

Only rarely are there more than five or six key factors for future competitive success. Managers should therefore resist the temptation to label a factor that has only minor importance 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.

Question 7: Does the Industry Offer Good Prospects for Attractive Profits?

LO4 Learn how to determine whether an industry's outlook presents a company with sufficiently attractive opportunities for growth and profitability.

The final step in evaluating the industry and competitive environment is boiling down the results of the analyses performed in Questions 1–6 to determine if the industry offers a company strong prospects for attractive profits.

The important factors on which to base such a conclusion include:

- The industry's growth potential.
- Whether powerful competitive forces are squeezing industry profitability to subpar levels and whether competition appears destined to grow stronger or weaker.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- The company's competitive position in the industry vis-à-vis rivals. (Well-entrenched leaders or strongly positioned contenders have a much better chance of earning attractive margins than those fighting a steep uphill battle.)
- How competently the company performs industry key success factors.

The degree to which an industry is attractive or unattractive is not the same for all industry participants and potential new entrants. The attractiveness of an industry depends on the degree of fit between a company's competitive capabilities and industry key success factors.

It is a mistake to think of a particular industry as being equally attractive or unattractive to all industry participants and all potential entrants. Conclusions have to be drawn from the perspective of a particular company. Industries attractive to insiders may be unattractive to outsiders. Industry environments unattractive to weak competitors may be attractive to strong competitors. A favorably positioned company may survey a business environment and see a host of opportunities that weak competitors cannot capture.

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. When a strong competitor concludes an industry is relatively unattractive, it may elect to simply protect its present position, investing cautiously if at all, and begin looking 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.

KEY POINTS

Thinking strategically about a company's external situation involves probing for answers to the following eight questions:

1. *What are the strategically relevant factors in the macro-environment?* Industries differ as to how they are affected by conditions in the broad macro-environment. PESTEL analysis of the political, economic, sociocultural, technological, environmental/ecological, and legal/regulatory factors provides a framework for approaching this issue systematically.
2. *What are the industry's dominant economic features?* Industries may also differ significantly on such factors as market size and growth rate, the number and relative sizes of both buyers and sellers, the geographic scope of competitive rivalry, the degree of product differentiation, the speed of product innovation, demand-supply conditions, the extent of vertical integration, and the extent of scale economies and learning curve effects.
3. *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) competitive pressures stemming from buyer bargaining power and seller-buyer collaboration, (2) competitive pressures associated with the sellers of substitutes, (3) competitive pressures stemming from supplier bargaining power and supplier-seller collaboration, (4) competitive pressures associated with the threat of new entrants into the market, and (5) competitive pressures stemming from the competitive jockeying among industry rivals.
4. *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 forces are in motion that create incentives or pressures for change. The first phase is to identify the forces that are driving industry change. The second phase of driving forces analysis is to determine whether the driving forces, taken together, are acting to make the industry environment more or less attractive.
5. *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 and differences 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. Some strategic groups are more favorable than others. The profit potential of different strategic

groups may not be the same because industry driving forces and competitive forces likely have varying effects on the industry's distinct strategic groups.

6. *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 in designing their own company's best course of action.
7. *What are the key factors for competitive success?* An industry's key success factors (KSFs) are the particular product attributes, competitive capabilities, and intangible assets 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 competitive success that *all firms* in the industry must pay close attention to them or risk being driven out of the industry.
8. *Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?* Conclusions regarding industry attractiveness are a major driver of company strategy. When a company decides an industry is fundamentally attractive and presents good opportunities, a strong case can be made that it should invest aggressively to capture the opportunities it sees. 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 looking 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. On occasion, an industry that is unattractive overall is still very attractive to a favorably situated company with the skills and resources to take business away from weaker rivals.

ASSURANCE OF LEARNING EXERCISES

LO2

connect

1. Prepare a brief analysis of the coffee industry using the information provided on industry trade association websites. Based upon information provided on the websites of these associations, draw a five-forces diagram for the coffee industry and briefly discuss the nature and strength of each of the five competitive forces.

LO3

connect

2. Based on the strategic group map in Concepts & Connections 3.1, who are Nordstrom's closest competitors? Between which two strategic groups is competition the strongest? Why do you think no retail chains are positioned in the upper-right corner of the map? Which company/strategic group faces the weakest competition from the members of other strategic groups?

LO1, LO4

3. The National Restaurant Association publishes an annual industry factbook that can be found at www.restaurant.org. Based on information in the latest report, does it appear that macro-environmental factors and the economic characteristics of the industry will present industry participants with attractive opportunities for growth and profitability? Explain.

EXERCISES FOR SIMULATION PARTICIPANTS

LO1, LO2, LO3, LO4

1. Which of the five competitive forces is creating the strongest competitive pressures for your company?
2. What are the "weapons of competition" that rival companies in your industry can use to gain sales and market share? See Figure 3.7 to help you identify the various competitive factors.
3. What are the factors affecting the intensity of rivalry in the industry in which your company is competing? Use Figure 3.7 and the accompanying discussion to help you in pinpointing the specific factors most affecting competitive intensity. Would you characterize the rivalry and jockeying for better market position, increased sales, and market share among the companies in your industry as fierce, very strong, strong, moderate, or relatively weak? Why?
4. Are there any driving forces in the industry in which your company is competing? What impact will these driving forces have? Will they cause competition to be more or less intense? Will they act to boost or squeeze profit margins? List at least two actions your company should consider taking to combat any negative impacts of the driving forces.
5. Draw a strategic group map showing the market positions of the companies in your industry. Which companies do you believe are in the most attractive position on the map? Which companies are the most weakly positioned? Which companies do you believe are likely to try to move to a different position on the strategic group map?
6. What do you see as the key factors for being a successful competitor in your industry? List at least three.
7. Does your overall assessment of the industry suggest that industry rivals have sufficiently attractive opportunities for growth and profitability? Explain.

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