Strategic Management

Need of Strategic Management:-

1. Due to change
2. To provide guide lines
3. Research and development
4. Probability for business performance
5. Systemized decision
6. Improves Communication
7. Allocation of resource
8. Improves Coordination
9. Helps the managers to have holistic approach

Importance of Strategic Management:-

1. To the shape the Future of business
2. Effective strategic idea
3. Mangers and employer are innovative and creative
4. Its decentralized the Management
5. Its helps to increase the productivity
6. To Makes discipline
7. To Make control

8. To makes forward s thinking

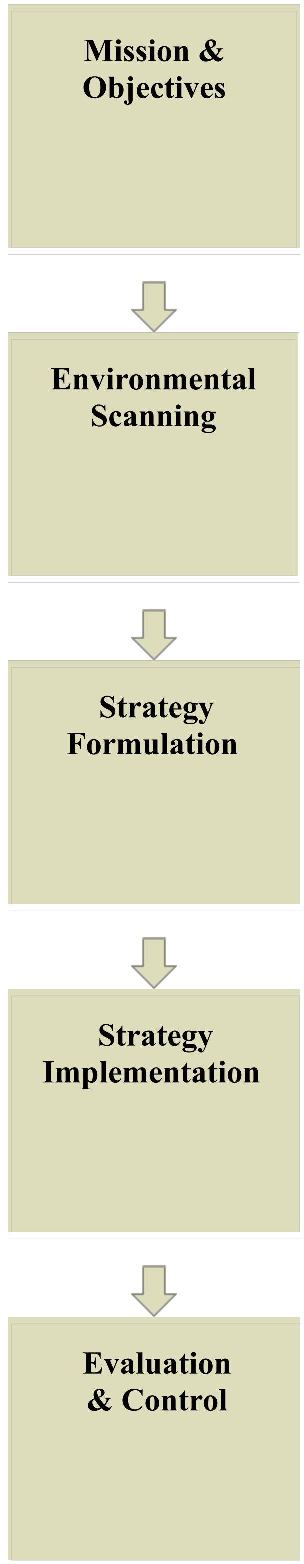
The Strategic Planning Process:

In today's highly competitive business environment, budget-oriented planning or forecast-based planning methods are insufficient for a large corporation to survive and prosper. The firm must engage in **strategic planning** that clearly defines objectives and assesses both the internal and external situation to formulate strategy, implement the strategy, evaluate the progress, and make adjustments as necessary to stay on track.

A simplified view of the strategic planning process is shown by the following diagram:

The Strategic Planning Process

The Strategic Planning Process



Mission and Objectives

The mission statement describes the company's business vision, including the unchanging values and purpose of the firm and forward-looking visionary goals that guide the pursuit of future opportunities.

Guided by the business vision, the firm's leaders can define measurable financial and strategic objectives. Financial objectives involve measures such as sales targets and earnings growth. Strategic objectives are related to the firm's business position, and may include measures such as market share and reputation.

Environmental Scan

The environmental scan includes the following components:

- Internal analysis of the firm
- Analysis of the firm's industry (task environment)
- External microenvironment (PEST analysis)

The internal analysis can identify the firm's strengths and weaknesses and the external analysis reveals opportunities and threats. A profile of the strengths, weaknesses, opportunities, and threats is generated by means of a SWOT analysis

An industry analysis can be performed using a framework developed by Michael Porter known as Porter's five forces. This framework evaluates entry barriers, suppliers, customers, substitute products, and industry rivalry.

Strategy Formulation

Given the information from the environmental scan, the firm should match its strengths to the opportunities that it has identified, while addressing its weaknesses and external threats.

To attain superior profitability, the firm seeks to develop a competitive advantage over its rivals. A competitive advantage can be based on cost or differentiation. Michael Porter identified three industry-independent generic strategies from which the firm can choose.

Strategy Implementation

The selected strategy is implemented by means of programs, budgets, and procedures. Implementation involves organization of the firm's resources and motivation of the staff to achieve objectives.

The way in which the strategy is implemented can have a significant impact on whether it will be successful. In a large company, those who implement the strategy likely will be different people from those who formulated it. For this reason, care must be taken to communicate the strategy and the reasoning behind it. Otherwise, the implementation might not succeed if the strategy is misunderstood or if lower-level managers resist its implementation because they do not understand why the particular strategy was selected.

Evaluation & Control

The implementation of the strategy must be monitored and adjustments made as needed.

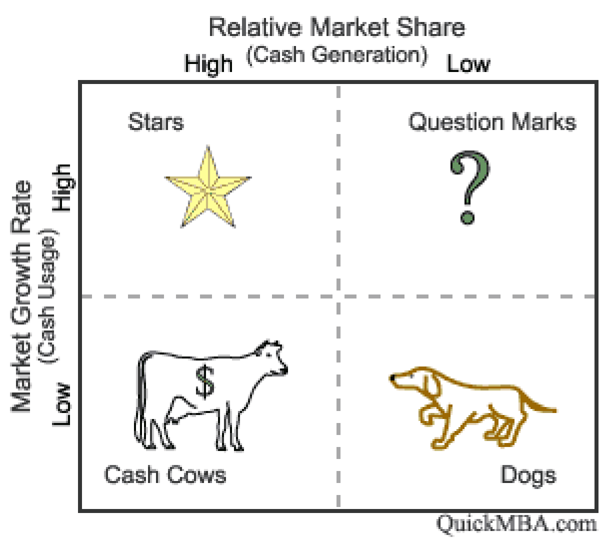
Evaluation and control consists of the following steps:

1. Define parameters to be measured
2. Define target values for those parameters
3. Perform measurements
4. Compare measured results to the pre-defined standard
5. Make necessary changes

BCG Growth-Share Matrix

Companies that are large enough to be organized into strategic business units face the challenge of allocating resources among those units. In the early 1970's the Boston Consulting Group developed a model for managing a portfolio of different business units (or major product lines). The BCG **growth-share matrix** displays the various business units on a graph of the market growth rate vs. market share relative to competitors:

BCG Growth-Share Matrix



Resources are allocated to business units according to where they are situated on the grid as follows:

- **Cash Cow** - a business unit that has a large market share in a mature, slow growing industry. Cash cows require little investment and generate cash that can be used to invest in other business units.
- **Star** - a business unit that has a large market share in a fast growing industry. Stars may generate cash, but because the market is growing rapidly they require investment to maintain their lead. If successful, a star will become a cash cow when its industry matures.
- **Question Mark (or Problem Child)** - a business unit that has a small market share in a high growth market. These business units require resources to grow market share, but whether they will succeed and become stars is unknown.
- **Dog** - a business unit that has a small market share in a mature industry. A dog may not require substantial cash, but it ties up capital that could better be deployed elsewhere. Unless a dog has some other strategic purpose, it should be liquidated if there is little prospect for it to gain market share.

The BCG matrix provides a framework for allocating resources among different business units and allows one to compare many business units at a glance. However, the approach has received some negative criticism for the following reasons:

- The link between market share and profitability is questionable since increasing market share can be very expensive.
- The approach may overemphasize high growth, since it ignores the potential of declining markets.
- The model considers market growth rate to be a given. In practice the firm may be able to grow the market.

These issues are addressed by the GE / McKinsey Matrix, which considers market growth rate to be only one of many factors that make an industry attractive, and which considers relative market share to be only one of many factors describing the competitive strength of the business unit.

The Business Vision and Company Mission Statement

While a business must continually adapt to its competitive environment, there are certain core ideals that remain relatively steady and provide guidance in the process of strategic decision-making. These unchanging ideals form the **business vision** and are expressed in the company **mission statement**.

In their 1996 article entitled *Building Your Company's Vision*, James Collins and Jerry Porras provided a framework for understanding business vision and articulating it in a mission statement.

The mission statement communicates the firm's core ideology and visionary goals, generally consisting of the following three components:

1. **Core values** to which the firm is committed
2. **Core purpose** of the firm
3. **Visionary goals** the firm will pursue to fulfill its mission

The firm's core values and purpose constitute its core ideology and remain relatively constant. They are independent of industry structure and the product life cycle.

The core ideology is not created in a mission statement; rather, the mission statement is simply an expression of what already exists. The specific phrasing of the ideology may change with the times, but the underlying ideology remains constant.

The three components of the business vision can be portrayed as follows:

Core Values

**Core Purpos
e**

Business Vision

Core Values

The core values are a few values (no more than five or so) that are central to the firm. Core values reflect the deeply held values of the organization and are independent of the current industry environment and management fads.

One way to determine whether a value is a core value to ask whether it would continue to be supported if circumstances changed and caused it to be seen as a liability. If the answer is that it would be kept, then it is core value. Another way to determine which values are core is to imagine the firm moving into a totally different industry. The values that would be carried with it into the new industry are the core values of the firm.

Core values will not change even if the industry in which the company operates changes. If the industry changes such that the core values are not appreciated, then the firm should seek new markets where its core values are viewed as an asset.

For example, if innovation is a core value but then 10 years down the road innovation is no longer valued by the current customers, rather than change its values the firm should seek new markets where innovation is advantageous.

The following are a few examples of values that some firms has chosen to be in their core:

- excellent customer service
- pioneering technology
- creativity
- integrity
- social responsibility

Core Purpose

The core purpose is the reason that the firm exists. This core purpose is expressed in a carefully formulated mission statement. Like the core values, the core purpose is relatively unchanging and for many firms endures for decades or even centuries. This purpose sets the firm apart from other firms in its industry and sets the direction in which the firm will proceed.

The core purpose is an idealistic reason for being. While firms exist to earn a profit, the profit motive should not be highlighted in the mission statement since it provides little direction to the firm's employees. What is more important is *how* the firm will earn its profit since the "how" is what defines the firm.

Initial attempts at stating a core purpose often result in too specific of a statement that focuses on a product or service. To isolate the core purpose, it is useful to ask "why" in response to first-pass, product-oriented mission statements. For example, if a market research firm initially states that its purpose is to provide market research data to its customers, asking "why" leads to the fact that the data is to help customers better understand their markets. Continuing to ask "why" may lead to the revelation that the firm's core purpose is to assist its clients in reaching their objectives by helping them to better understand their markets.

The core purpose and values of the firm are not selected - they are discovered. The stated ideology should not be a goal or aspiration but rather, it should portray the firm as it really is. Any attempt to state a value that is not already held by the firm's employees is likely to not be taken seriously.

Visionary Goals

The visionary goals are the lofty objectives that the firm's management decides to pursue. This vision describes some milestone that the firm will reach in the future and may require a decade or more to achieve. In contrast to the core ideology that the firm discovers, visionary goals are selected.

These visionary goals are longer term and more challenging than strategic or tactical goals. There may be only a 50% chance of realizing the vision, but the firm must believe that it can do so. Collins and Porras describe these lofty objectives as "Big, Hairy, Audacious Goals." These goals should be challenging enough so that people nearly gasp when they learn of them and realize the effort that will be required to reach them.

Most visionary goals fall into one of the following categories:

- **Target** - quantitative or qualitative goals such as a sales target or Ford's goal to "democratize the automobile."
- **Common enemy** - centered on overtaking a specific firm such as the 1950's goal of Philip-Morris to displace RJR.
- **Role model** - to become like another firm in a different industry or market. For example, a cycling accessories firm might strive to become "the Nike of the cycling industry."
- **Internal transformation** - especially appropriate for very large corporations. For example, GE set the goal of becoming number one or number two in every market it serves.

While visionary goals may require significant stretching to achieve, many visionary companies have succeeded in reaching them. Once such a goal is reached, it needs to be replaced; otherwise, it is unlikely that the organization will continue to be successful. For example, Ford succeeded in placing the automobile within the reach of everyday people, but did not replace this goal with a better one and General Motors overtook Ford in the 1930's.

Competitive Advantage

When a firm sustains profits that exceed the average for its industry, the firm is said to possess a competitive advantage over its rivals. The goal of much of business strategy is to achieve a sustainable competitive advantage.

Michael Porter identified two basic types of competitive advantage:

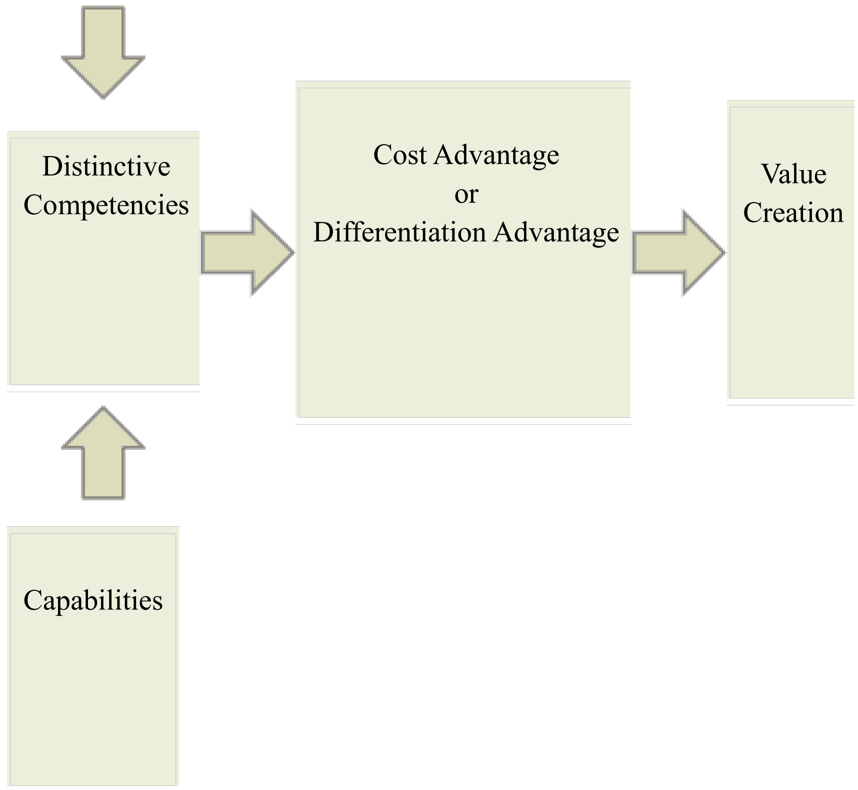
- **Cost advantage**
- **Differentiation advantage**

A competitive advantage exists when the firm is able to deliver the same benefits as competitors but at a lower cost (cost advantage), or deliver benefits that exceed those of competing products (differentiation advantage). Thus, a competitive advantage enables the firm to create superior value for its customers and superior profits for itself.

Cost and differentiation advantages are known as *positional advantages* since they describe the firm's position in the industry as a leader in either cost or differentiation.

A *resource-based view* emphasizes that a firm utilizes its resources and capabilities to create a competitive advantage that ultimately results in superior value creation. The following diagram combines the resource-based and positioning views to illustrate the concept of competitive advantage:

A Model of Competitive Advantage



Resources and Capabilities

According to the resource-based view, in order to develop a competitive advantage the firm must have resources and capabilities that are superior to those of its competitors. Without this superiority, the competitors simply could replicate what the firm was doing and any advantage quickly would disappear.

Resources are the firm-specific assets useful for creating a cost or differentiation advantage and that few competitors can acquire easily. The following are some examples of such resources:

- Patents and trademarks
- Proprietary know-how
- Installed customer base
- Reputation of the firm
- Brand equity

Capabilities refer to the firm's ability to utilize its resources effectively. An example of a capability is the ability to bring a product to market faster than competitors.

Such capabilities are embedded in the routines of the organization and are not easily documented as procedures and thus are difficult for competitors to replicate.

The firm's resources and capabilities together form its **distinctive competencies**. These competencies enable innovation, efficiency, quality, and customer responsiveness, all of which can be leveraged to create a cost advantage or a differentiation advantage.

Cost Advantage and Differentiation Advantage

Competitive advantage is created by using resources and capabilities to achieve either a lower cost structure or a differentiated product. A firm positions itself in its industry through its choice of low cost or differentiation. This decision is a central component of the firm's competitive strategy.

Another important decision is how broad or narrow a market segment to target. Porter formed a matrix using cost advantage, differentiation advantage, and a broad or narrow focus to identify a set of generic strategies that the firm can pursue to create and sustain a competitive advantage.

Value Creation

The firm creates value by performing a series of activities that Porter identified as the value chain. In addition to the firm's own value-creating activities, the firm operates in a *value system* of vertical activities including those of upstream suppliers and downstream channel members.

To achieve a competitive advantage, the firm must perform one or more value creating activities in a way that creates more overall value than do competitors. Superior value is created through lower costs or superior benefits to the consumer (differentiation).

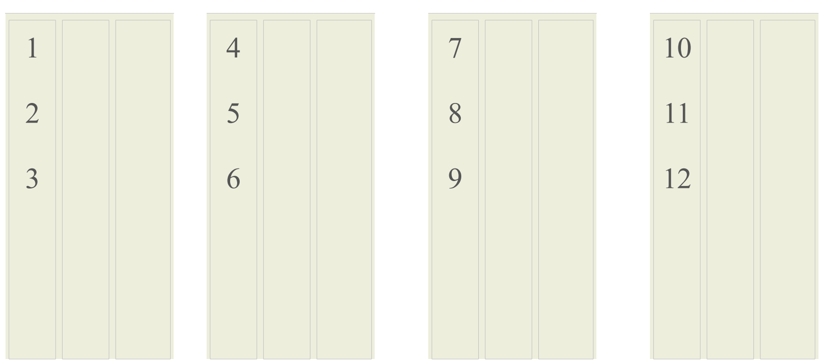
Core Competencies

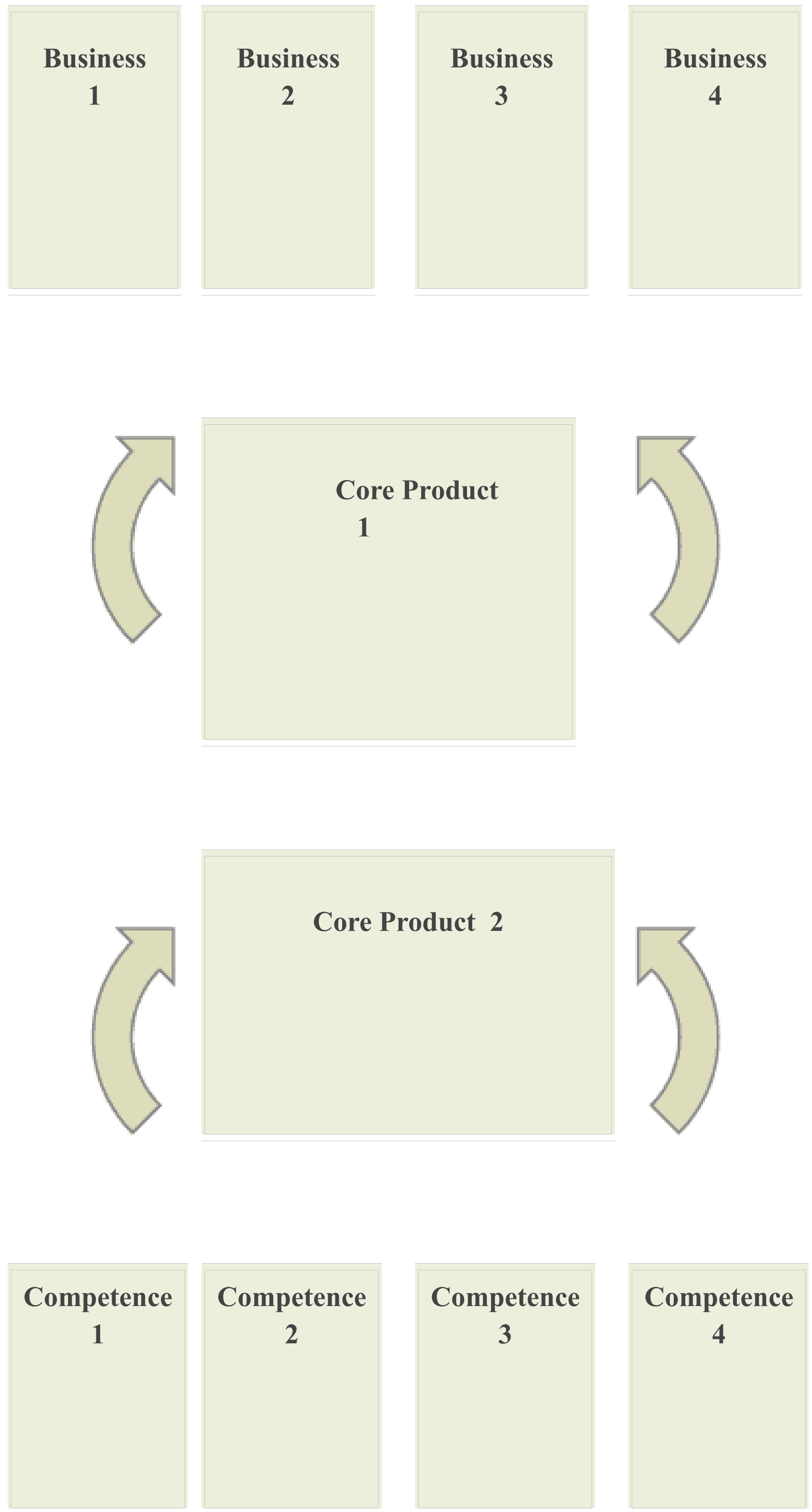
In their 1990 article entitled, *The Core Competence of the Corporation*, C.K. Prahalad and Gary Hamel coined the term **core competencies**, or the collective learning and coordination skills behind the firm's product lines. They made the case that core competencies are the source of competitive advantage and enable the firm to introduce an array of new products and services.

According to Prahalad and Hamel, core competencies lead to the development of core products. Core products are not directly sold to end users; rather, they are used to build a larger number of end-user products. For example, motors are a core product that can be used in wide array of end products. The business units of the corporation each tap into the relatively few core products to develop a larger number of end user products based on the core product technology. This flow from core competencies to end products is shown in the following diagram:

Core Competencies to End Products

End Products




Business 1
Business 2
Business 3
Business 4
Core Product 1
Core Product 2
Competence 1
Competence 2
Competence 3
Competence 4

The intersection of market opportunities with core competencies forms the basis for launching new businesses. By combining a set of core competencies in different ways and matching them to market opportunities, a corporation can launch a vast array of businesses.

Without core competencies, a large corporation is just a collection of discrete businesses. Core competencies serve as the glue that bonds the business units together into a coherent portfolio.

Developing Core Competencies

According to Prahalad and Hamel, core competencies arise from the integration of multiple technologies and the coordination of diverse production skills. Some examples include Philip's expertise in optical media and Sony's ability to miniaturize electronics.

There are three tests useful for identifying a core competence. A core competence should:

1. provide access to a wide variety of markets, and
2. contribute significantly to the end-product benefits, and
3. be difficult for competitors to imitate.

Core competencies tend to be rooted in the ability to integrate and coordinate various groups in the organization. While a company may be able to hire a team of brilliant scientists in a particular technology, in doing so it does not automatically gain a core competence in that technology. It is the effective coordination among all the groups involved in bringing a product to market that results in a core competence.

It is not necessarily an expensive undertaking to develop core competencies. The missing pieces of a core competency often can be acquired at a low cost through alliances and licensing agreements. In many cases an organizational design that facilitates sharing of competencies can result in much more effective utilization of those competencies for little or no additional cost.

To better understand how to develop core competencies, it is worthwhile to understand what they do not entail. According to Prahalad and Hamel, core competencies are <u>not</u> necessarily about:

- outspending rivals on R&D
- sharing costs among business units
- integrating vertically

While the building of core competencies may be facilitated by some of these actions, by themselves they are insufficient.

The Loss of Core Competencies

Cost-cutting moves sometimes destroy the ability to build core competencies. For example, decentralization makes it more difficult to build core competencies because autonomous groups rely on outsourcing of critical tasks, and this outsourcing prevents the firm from developing core competencies in those tasks since it no longer consolidates the know-how that is spread throughout the company.

Failure to recognize core competencies may lead to decisions that result in their loss. For example, in the 1970's many U.S. manufacturers divested themselves of their television manufacturing businesses, reasoning that the industry was mature and that high quality, low cost models were available from Far East manufacturers. In the process, they lost their core competence in video, and this loss resulted in a handicap in the newer digital television industry.

Similarly, Motorola divested itself of its semiconductor DRAM business at 256Kb level, and then was unable to enter the 1Mb market on its own. By recognizing its core competencies and understanding the time required to build them or regain them, a company can make better divestment decisions.

Core Products

Core competencies manifest themselves in core products that serve as a link between the competencies and end products. Core products enable value creation in the end products. Examples of firms and some of their core products include:

- 3M - substrates, coatings, and adhesives
- Black & Decker - small electric motors

- Canon - laser printer subsystems
- Matsushita - VCR subsystems, compressors
- NEC - semiconductors
- Honda - gasoline powered engines

The core products are used to launch a variety of end products. For example, Honda uses its engines in automobiles, motorcycles, lawn mowers, and portable generators.

Because firms may sell their core products to other firms that use them as the basis for end user products, traditional measures of brand market share are insufficient for evaluating the success of core competencies. Prahalad and Hamel suggest that *core product share* is the appropriate metric. While a company may have a low brand share, it may have high core product share and it is this share that is important from a core competency standpoint.

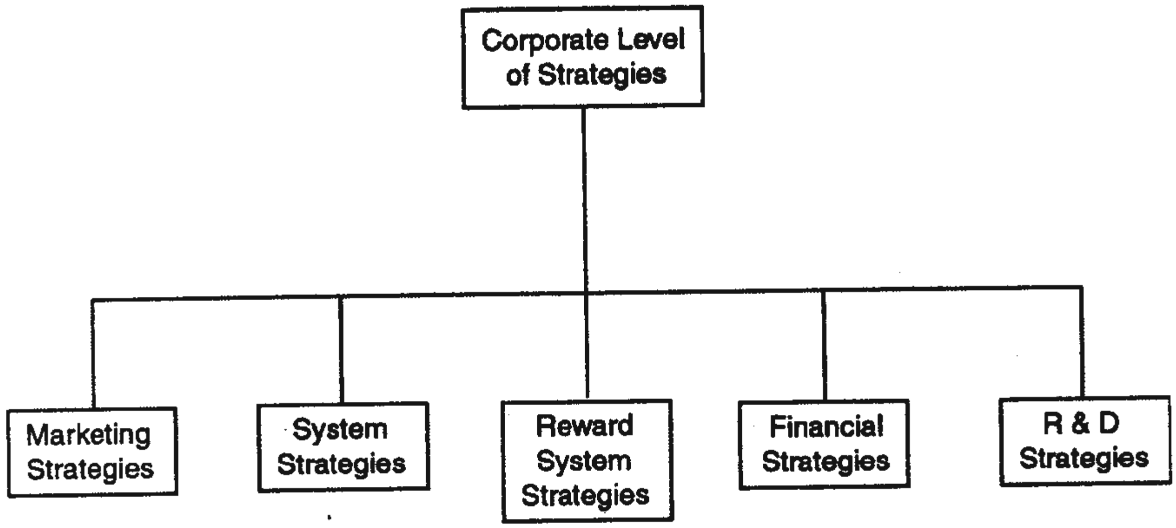
Once a firm has successful core products, it can expand the number of uses in order to gain a cost advantage via economies of scale and economies of scope.

Implications for Corporate Management

Prahalad and Hamel suggest that a corporation should be organized into a portfolio of core competencies rather than a portfolio of independent business units. Business unit managers tend to focus on getting immediate end-products to market rapidly and usually do not feel responsible for developing company-wide core competencies. Consequently, without the incentive and direction from corporate management to do otherwise, strategic business units are inclined to underinvest in the building of core competencies.

If a business unit does manage to develop its own core competencies over time, due to its autonomy it may not share them with other business units. As a solution to this problem, Prahalad and Hamel suggest that corporate managers should have the ability to allocate not only cash but also core competencies among business units. Business units that lose key employees for the sake of a corporate core competency should be recognized for their contribution.

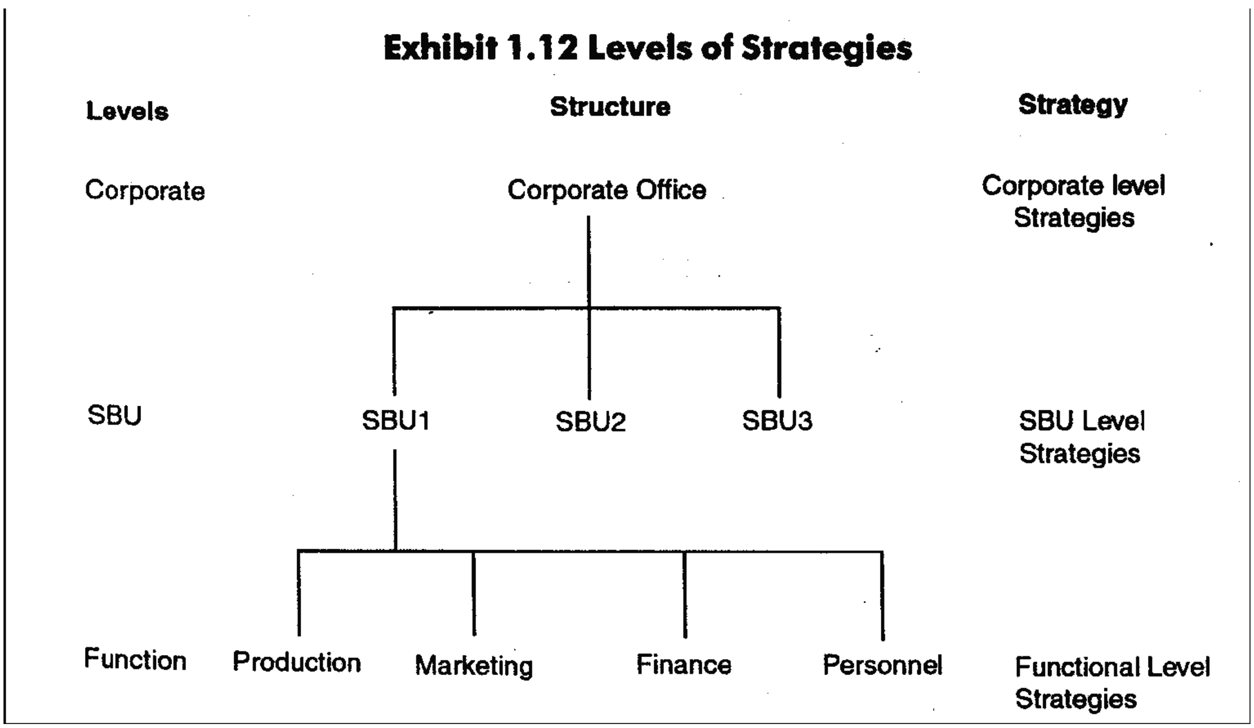
Corporate Strategy:

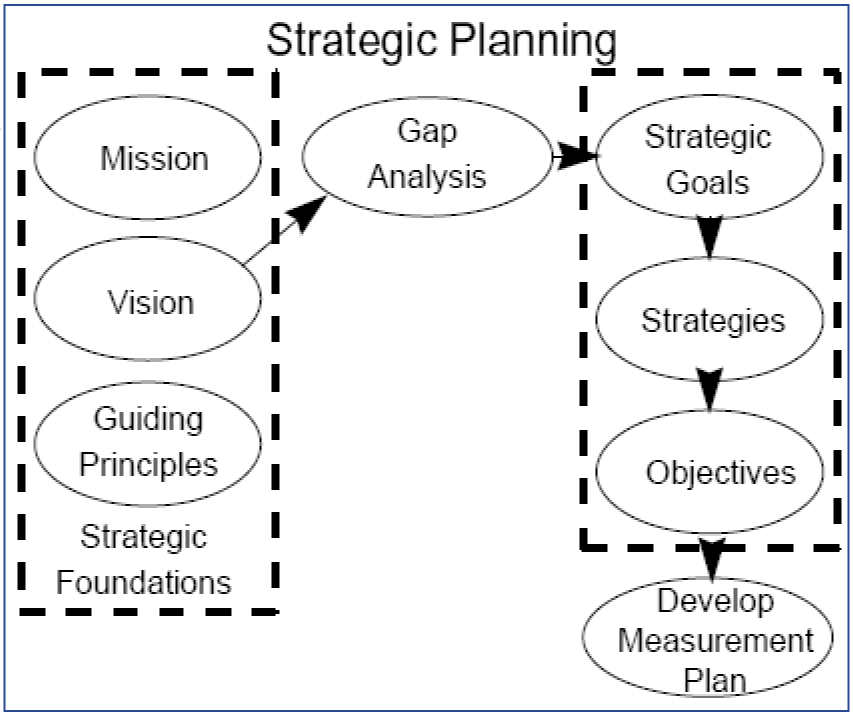

Corporate Level of Strategies
Marketing Strategies
System Strategies
Reward System Strategies
Financial Strategies
R & D Strategies

Difference Between Long-Range Planning and Strategic Planning

	Long-Range Planning	Strategic Planning
Focus	Present	Growth
Objective	Annual Profits	Future Profits and share
Constraints	Present Resources Environment	Future Resources Environment
Rewards	Efficiency, Stability	Development of Future Potential
Risks	No growth	Slow Process, Requires Effort
Information	Present Business	Present Business, Future Opportunities, threats etc.
Organization	Bureaucratic/Stable	Entrepreneurial/Flexible
Leadership	Conservative	Creative
Problem Solving	Reacts, Relies on Past Experience Low Risk	Anticipates, Discovers Creative Approaches High Risk

Types of Corporate Strategy:





Strategic Management Concepts

Although the term "strategic management" is bantered around a lot in the businesses world, it is not understood very well by most people. Essentially strategic management answers the questions of "where do you want your business to go" (goals), "how is your business going to get there" (strategy) and "how will you know when you get there" (evaluation). A strategic management analogy is taking a trip during your vacation. First you decide where you want to go – the natural beauty of Yellowstone or the bright lights of Las Vegas. Then you develop a strategy of how to get there – take an airplane (which flights), drive your car (which highways), etc. This will be influenced by the amount of money, time and
Other resources you have available. Then you monitor your trip to see if your strategy takes you to your destination and how your strategy worked (missed
Flights, poor road conditions, etc.). Below are concepts to help expand your understand of strategic management for a business. These will help sharpen your focus for using Strategic Management for a Value-added Farm Business.

1) Strategic management involves deciding what is important for the long-range success of your business and focusing on it.

2) Strategic management asks, "How should I position my business to meet management and business goals?"

3) A business strategy is a series of business decisions that lead to achieving a business goal.

4) Strategic management involves the "big picture" of your business.

5) Strategic management involves planning, analyzing and implementing a business strategy.

6) Strategic management is most effective if you can step back far enough and say "all things are possible."

7) The essence of strategic management is matching business resources to market opportunities.

8) Strategic management involves seeking and identifying opportunities and threats in the market and industry and the outside world in general.

9) Strategic management is based on the premise that "all businesses are not the same."

10) Strategic management involves assessing the strengths and weaknesses of your business.

11) When assessing strengths and weaknesses, personal skills and abilities are likely to be more important than business assets.

12) Strategic management involves looking into the future rather than dwelling on the past.

13) Strategic management is proactive rather than reactive.

14) Strategic management involves anticipating change and taking advantage of it.

15) Strategic thinking involves assessing how decisions made today will affect my business in the future.

16) Strategic management is more of a state-of mind than a rigid process.

17) A military connotation of strategic management is "it hasn't won every war, but it has avoided a lot of ambushes."

18) Strategic management is most useful for businesses with unique or differentiated products for niche, specialty or differentiated product Markets.

19) Strategic planning comes before business planning. Strategic planning is used to identify and assess alternative business strategies. Business planning is used to implement a business strategy.

20) Strategic planning is more words and less numbers than business planning.

21) A strategic plan is a "living" document that changes as your goals and resources evolve.

Strategic management

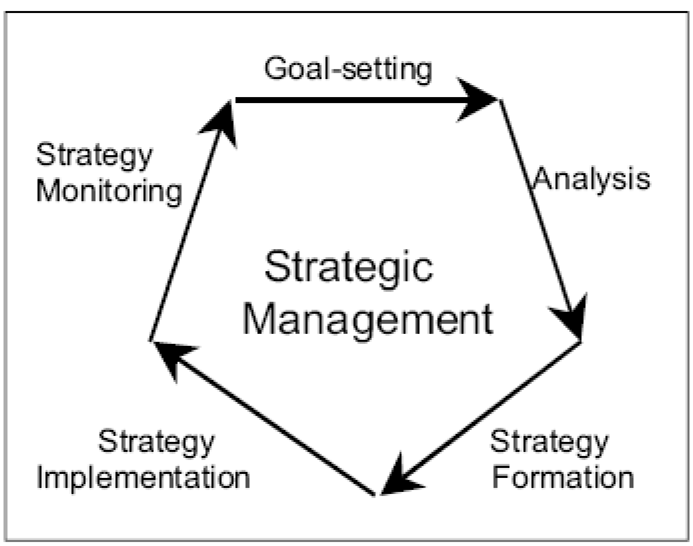


Table 5.1. Five Facets of Strategic Management

Goal-Setting	Goal-setting enables you to articulate your vision: identify what needs to be accomplished, define short- and long-term objectives, and relate them to what your organization needs to do. A “mission statement” summarizes your purpose and goals in terms easily understood by both staff and external stakeholders.
Analysis	Analysis guides you to collect and consider information so that you fully understand your situation. Assess external environments and internal situations to identify the strengths and weaknesses of your organization and the opportunities and threats you face as you seek to reach your goals.
Strategy Formation	To determine a strategy, you reflect, prioritize, develop options, and make decisions. Review the results of the analyses, identify the issues that you and your implementing partners need to address, and prioritize them in terms of their urgency and magnitude. Use these results to design alternative strategies and plans that address the key strategic issues.
Strategy Implementation	To implement your strategy, assemble the necessary resources and apply them. Put the chosen plans into practice, marshal the resources and commitments necessary for moving ahead, tap existing capacity and/or build new capacity, and seek to achieve results.
Strategy Monitoring	Monitoring allows you to check your progress toward achieving your goals and assess whether any changes in the environment necessitate alterations to your strategy. Modify plans and actions to adjust to the impact of changes in the operating environment. Effective monitoring allows you to react and anticipate. Monitoring also feeds back into analysis, strategy design, and implementation in the immediate term and into goal-setting over the longer term.

Global Strategic Management

During the last half of the twentieth century, many barriers to international trade fell and a wave of firms began pursuing global strategies to gain a competitive advantage. However, some industries benefit more from globalization than do others, and some nations have a comparative advantage over other nations in certain industries. To create a successful global strategy, managers first must understand the nature of global industries and the dynamics of global competition.

Sources of Competitive Advantage from a Global Strategy

A well-designed global strategy can help a firm to gain a competitive advantage. This advantage can arise from the following sources:

- **Efficiency**

- Economies of scale from access to more customers and markets
    - Exploit another country's resources - labor, raw materials
    - Extend the product life cycle - older products can be sold in lesser developed countries
    - Operational flexibility - shift production as costs, exchange rates, etc. change over time

- **Strategic**
    - First mover advantage and only provider of a product to a market
    - Cross subsidization between countries
    - Transfer price

- **Risk**
    - Diversify macroeconomic risks (business cycles not perfectly correlated among countries)
    - Diversify operational risks (labor problems, earthquakes, wars)

- **Learning**
    - Broaden learning opportunities due to diversity of operating environments

- **Reputation**
    - Crossover customers between markets - reputation and brand identification

Sumantra Ghoshal of INSEAD proposed a framework comprising three categories of strategic objectives and three sources of advantage that can be used to achieve them. Assembling these into a matrix results in the following framework:

Strategic Objectives	*Sources of Competitive Advantage*		
	National Differences	**Scale Economies**	**Scope Economies**
Efficiency in Operations	Exploit factor cost differences	Scale in each activity	Sharing investments and costs
Flexibility	Market or policy-induced changes	Balancing scale with strategic & operational risks	Portfolio diversification
Innovation and	Societal differences in	Experience - cost reduction	Shared learning across

The Nature of Competitive Advantage in Global Industries

A global industry can be defined as:

- An industry in which firms must compete in all world markets of that product in order to survive.
- An industry in which a firm's competitive advantage depends on economies of scale and economies of scope gained across markets.

Some industries are more suited for globalization than are others. The following drivers determine an industry's globalization potential.

1. **Cost Drivers**
    - Location of strategic resources
    - Differences in country costs
    - Potential for economies of scale (production, R&D, etc.) Flat experience curves in an industry inhibits globalization. One reason that the facsimile industry had more global potential than the furniture industry is that for fax machines, the production costs drop 30%-40% with each doubling of volume; the curve is much flatter for the furniture industry and many service industries. Industries for which the larger expenses are in R&D, such as the aircraft industry, exhibit more economies of scale than those industries for which the larger expenses are rent and labor, such as the dry cleaning industry. Industries in which costs drop by at least 20% for each doubling of volume tend to be good candidates for globalization.
    - Transportation costs (value/bulk or value/weight ratio) => Diamonds and semiconductors are more global than ice.

2. **Customer Drivers**
    - Common customer needs favor globalization. For example, the facsimile industry's customers have more homogeneous needs than those of the furniture industry, whose needs are defined by local tastes, culture, etc.

- Global customers: if a firm's customers are other global businesses, globalization may be required to reach these customers in all their markets. Furthermore, global customers often require globally standardized products.
- Global channels require a globally coordinated marketing program. Strong established local distribution channels inhibits globalization.
- Transferable marketing: whether marketing elements such as brand names and advertising require little local adaptation. World brands with non-dictionary names may be developed in order to benefit from a single global advertising campaign.

3. **Competitive Drivers**
   - Global competitors: The existence of many global competitors indicates that an industry is ripe for globalization. Global competitors will have a cost advantage over local competitors.
   - When competitors begin leveraging their global positions through cross-subsidization, an industry is ripe for globalization.

4. **Government Drivers**
   - Trade policies
   - Technical standards
   - Regulations

The furniture industry is an example of an industry that did not lend itself to globalization before the 1960's. Because furniture has a high bulk compared to its value, and because furniture is easily damaged in shipping, transport costs traditionally were high. Government trade barriers also were unfavorable. The Swedish furniture company IKEA pioneered a move towards globalization in the furniture industry. IKEA's furniture was unassembled and therefore could be shipped more economically. IKEA also lowered costs by involving the customer in the value chain; the customer carried the furniture home and assembled it himself. IKEA also had a frugal culture that gave it cost advantages. IKEA successfully expanded in Europe since customers in different countries were willing to purchase similar designs. However, after successfully expanding to several countries, IKEA ran into difficulties in the U.S. market for several reasons:

- Different tastes in furniture and a requirement for more customized furniture.
- Difficult to transfer IKEA's frugal culture to the U.S.
- The Swedish Krona increased in value, increasing the cost of furniture made in Sweden and sold in the U.S.
- Stock-outs due to the one to two month shipping time from Europe
- More competition in the U.S. than in Europe

Country Comparative Advantages

Competitive advantage is a firm's ability to transform inputs into goods and services at a maximum profit on a sustained basis, better than competitors. **Comparative** advantage resides in the factor endowments and created endowments of particular regions. Factor endowments include land, natural resources, labor, and the size of the local population.

In the 1920's, Swedish economists Eli Hecksher and Bertil Ohlin developed the factor-proportions theory, according to which a country enjoys a comparative advantage in those goods that make intensive use of factors that the country has in relative abundance.

Michael E. Porter argued that a nation can create its own endowments to gain a comparative advantage. Created endowments include skilled labor, the technology and knowledge base, government support, and culture. Porter's Diamond of National Advantage is a framework that illustrates the determinants of national advantage. This diamond represents the national playing field that countries establish for their industries.

Types of International Strategy: Multi-domestic vs. Global

Multi-domestic Strategy

- Product customized for each market
- Decentralized control - local decision making
- Effective when large differences exist between countries
- Advantages: product differentiation, local responsiveness, minimized political risk, minimized exchange rate risk

Global Strategy

- Product is the same in all countries.
- Centralized control - little decision-making authority on the local level
- Effective when differences between countries are small
- Advantages: cost, coordinated activities, faster product development

A fully multi-local value chain will have every function from R&D to distribution and service performed entirely at the local level in each country. At the other extreme, a fully global value chain will source each activity in a different country.

Philips is a good example of a company that followed a multidomestic strategy. This strategy resulted in:

- Innovation from local R&D
- Entrepreneurial spirit
- Products tailored to individual countries
- High quality due to backward integration

The multi-domestic strategy also presented Philips with many challenges:

- High costs due to tailored products and duplication across countries
- The innovation from the local R&D groups resulted in products that were R&D driven instead of market driven.
- Decentralized control meant that national buy-in was required before introducing a product - time to market was slow.

Matsushita is a good example of a company that followed a global strategy. This strategy resulted in:

- Strong global distribution network
- Company-wide mission statement that was followed closely
- Financial control
- More applied R&D
- Ability to get to market quickly and force standards since individual country buy-in was not necessary.

The global strategy presented Matsushita with the following challenges:

- Problem of strong yen
- Too much dependency on one product - the VCR
- Loss of non-Asian employees because of glass ceilings

A third strategy, which was appropriate to Whirlpool is one of mass customization, discussed below.

Global Cost Structure Analysis

In 1986, Whirlpool Corporation was considering expanding into Europe by acquiring Philips' Major Domestic Appliance Division. From the framework of customers, costs, competitors, and government, there were several pros and cons to this proposed strategy.

Pros

- Internal components of the appliances could be the same, offering economies of scale.
- The cost to customize the outer structure of the appliances was relatively low.
- The appliance industry was mature with low growth. The acquisition would offer an avenue to continue growing.

Cons

- Fragmented distribution network in Europe.
- Different consumer needs and preferences. For example, in Europe refrigerators tend to be smaller than in the U.S., have only one outside door, and have standard sizes so they can be built into the kitchen cabinet. In Japan, refrigerators tend to have several doors in order to keep different compartments at different temperatures and to isolate odors. Also, because houses are smaller in Japan, consumers desire quieter appliances.
- Whirlpool already was the dominant player in a fragmented industry.

Since Philip's had a relatively small market share in the European appliance market, one must analyze the cost structure to determine if the acquisition would offer

Whirlpool a competitive advantage. With the acquisition, Whirlpool would be able to cut costs on raw materials, depreciation and maintenance, R&D, and general and administrative costs. These costs represented 53% of Whirlpool's cost structure. Compared to most other industries, this percentage of costs that could benefit from economies of scale is quite large. It would be reasonable to expect a 10% reduction in these costs, an amount that would decrease overall cost by 5.3%, doubling profits. Such potential justifies the risk of increasing the complexity of the organization.

Because of the different preferences of consumers in different markets, a purely global strategy with standard products was not appropriate. Whirlpool would have to adapt its products to local markets, but maintain some global integration in order to realize cost benefits. This strategy is known as "mass customization."

Whirlpool acquired Philips' Major Domestic Appliance Division, 47% in 1989 and the remainder in 1991. Initially, margins doubled as predicted. However, local competitors responded by better tailoring their products and cutting costs; Whirlpool's profits then began to decline. Whirlpool applied the same strategy to Asia, but GE was outperforming Whirlpool there by tailoring its products as part of its multi-domestic strategy.

Globalizing Service Businesses

Service industries tend to have a flat experience curve and lower economies of scale. However, some economy of scale may be gained through knowledge sharing, which enables the cost of developing the knowledge over a larger base. Also, in some industries such as professional services, capacity utilization can better be managed as the scope of operations increases. On the customer side, because a service firm's customers may themselves be operating internationally, global expansion may be a necessity. Knowledge gained in foreign markets can used to better service customers. Finally, being global also enhances a firm's reputation, which is critical in service businesses.

High quality service products often depend on the service firm's culture, and maintaining a consistent culture when expanding globally is a challenge.

A good example of a service firm that experienced global expansion challenges is the management consulting firm Bain & Company, Inc. In consulting, a firm's most important strategic asset is its reputation, so a consistent firm culture is very important. Bain faced the following challenges, which depend on the firm's strategy and which affect the ability to maintain a consistent culture:

- Coordinating across offices and sharing knowledge
- Whether to hire locals or international staff
- How to compensate

Modes of Foreign Market Entry

An important part of a global strategy is the method that the firm will use to enter the foreign market. There are four possible modes of foreign market entry:

- Exporting
- Licensing (includes franchising)
- Joint Venture
- Foreign Direct Investment

These options vary in their degree of speed, control, and risk, as well as the required level of investment and market knowledge. The entry mode selection can have a significant impact on the firm's foreign market success.

Issues in Emerging Economies

In emerging economies, capital markets are relatively inefficient. There is a lack of information, the cost of capital is high, and venture capital is virtually nonexistent. Because of the scarcity of high-quality educational institutions, the labor markets lack well trained people and companies often must fill the void. Because of lacking communications infrastructure, building a brand name is difficult but good brands are highly valued because of lower product quality of the alternatives. Relationships with government officials often are necessary to succeed, and contracts may not be well enforced by the legal system.

When a large government monopoly (e.g. a state-owned oil company) is privatized, there often is political pressure in the country against allowing the firm to be acquired by a foreign entity. Whereas a very large U.S. oil company may prefer acquisitions, because of the anti-foreign sentiment joint ventures often are more appropriate for outside companies interested in newly privatized emerging economy firms.

Knowledge Management in Global Firms

There is much value in transferring knowledge and best practices between parts of a global firm. However, many barriers prevent knowledge from being transferred:

- Barriers attributable to the knowledge source
    - lack of motivation
    - lack of credibility
- Barriers attributable to the knowledge itself - ambiguity and complexity
- Barriers attributable to the knowledge recipient
    - lack of motivation (not invented here syndrome)
    - lack of absorptive capacity - need prerequisite knowledge to advance to next level
- Barriers attributable to the recipient's existing process - process rigidity
- Barriers attributable to the recipient's external environment and constraints

Furthermore, even when the transfer is successful, there often is a temporary drop in performance before the improvements are seen. During this period, there is danger of losing faith in the new way of doing things.

To facilitate knowledge transfer a firm can:

- Implement processes to systematically identify valuable knowledge and best practices.
- Create incentives to motivate both the knowledge source and recipient.
- Develop absorptive capacity in the recipient - cumulative knowledge
- Develop strong technical and social networks between parts of the firm that can share knowledge.

Country Management

Country managers must have the following knowledge:

- Knowledge of strategic management

- Firm-specific knowledge
- Country-specific knowledge
- Knowledge of the global environment

Country organizations can assume the role of implementor, contributor, strategic leader, or black hole, depending on the combination of importance of the local market and local resources.

Strategic Importance of Local Market	*Level of Local Resources & Capabilities*	
	Low	**High**
Low	Implementor	Contributor
High	Black Hole	Strategic Leader

The least favorable of these roles is the black hole, which is a subsidiary in a strategically important market that has few capabilities. A firm can find itself in this situation because of company traditions, ignorance of local conditions, unfavorable entry conditions, misreading the market, excessive reliance on expatriates, and poor external relations. To get out of a black hole a firm can form alliances, focus its investments, implement a local R&D organization, or when all else fails, exit the country.

Country managers assume different roles (*The New Country Managers*, John A. Quelch, Professor of Business Administration, Harvard Business School).

- International Structure: Country manager is a trader who implements policy.
- Multinational Structure: Country manager plays the role of a functional manager with profit and loss responsibilities.
- Transnational Structure: Country manager acts as a cabinet member (team player) since management control systems are standardized and decision-making power is shifted to the region manager. The country manager develops the lead market in his country and transfers the knowledge gained to other similar markets.
- Global Structure: Country manager acts as an ambassador and administrator. In a global firm there usually are business directors who oversee marketing

and sales. The role of the country manager becomes one of a statesman. This person usually is a local with good government contacts.

Hierarchical Levels of Strategy

Strategy can be formulated on three different levels:

- corporate level
- business unit level
- functional or departmental level.

While strategy may be about competing and surviving as a firm, one can argue that products, not corporations compete, and products are developed by business units. The role of the corporation then is to manage its business units and products so that each is competitive and so that each contributes to corporate purposes.

Consider Textron, Inc., a successful conglomerate corporation that pursues profits through a range of businesses in unrelated industries. Textron has four core business segments:

- Aircraft - 32% of revenues
- Automotive - 25% of revenues
- Industrial - 39% of revenues
- Finance - 4% of revenues.

While the corporation must manage its portfolio of businesses to grow and survive, the success of a diversified firm depends upon its ability to manage each of its product lines. While there is no single competitor to Textron, we can talk about the competitors and strategy of each of its business units. In the finance business segment, for example, the chief rivals are major banks providing commercial financing. Many managers consider the business level to be the proper focus for strategic planning.

Corporate Level Strategy

Corporate level strategy fundamentally is concerned with the selection of businesses in which the company should compete and with the development and coordination of that portfolio of businesses.

Corporate level strategy is concerned with:

- Reach - defining the issues that are corporate responsibilities; these might include identifying the overall goals of the corporation, the types of businesses in which the corporation should be involved, and the way in which businesses will be integrated and managed.
- Competitive Contact - defining where in the corporation competition is to be localized. Take the case of insurance: In the mid-1990's, Aetna as a corporation was clearly identified with its commercial and property casualty insurance products. The conglomerate Textron was not. For Textron, competition in the insurance markets took place specifically at the business unit level, through its subsidiary, Paul Revere. (Textron divested itself of The Paul Revere Corporation in 1997.)
- Managing Activities and Business Interrelationships - Corporate strategy seeks to develop synergies by sharing and coordinating staff and other resources across business units, investing financial resources across business units, and using business units to complement other corporate business activities. Igor Ansoff introduced the concept of synergy to corporate strategy.
- Management Practices - Corporations decide how business units are to be governed: through direct corporate intervention (centralization) or through more or less autonomous government (decentralization) that relies on persuasion and rewards.

Corporations are responsible for creating value through their businesses. They do so by managing their portfolio of businesses, ensuring that the businesses are successful over the long-term, developing business units, and sometimes ensuring that each business is compatible with others in the portfolio.

Business Unit Level Strategy

A strategic business unit may be a division, product line, or other profit center that can be planned independently from the other business units of the firm.

At the business unit level, the strategic issues are less about the coordination of operating units and more about developing and sustaining a competitive advantage for the goods and services that are produced. At the business level, the strategy formulation phase deals with:

- positioning the business against rivals
- anticipating changes in demand and technologies and adjusting the strategy to accommodate them
- influencing the nature of competition through strategic actions such as vertical integration and through political actions such as lobbying.

Michael Porter identified three generic strategies (*cost leadership*, *differentiation*, and *focus*) that can be implemented at the business unit level to create a competitive advantage and defend against the adverse effects of the five forces.

Functional Level Strategy

The functional level of the organization is the level of the operating divisions and departments. The strategic issues at the functional level are related to business processes and the value chain. Functional level strategies in marketing, finance, operations, human resources, and R&D involve the development and coordination of resources through which business unit level strategies can be executed efficiently and effectively.

Functional units of an organization are involved in higher level strategies by providing input into the business unit level and corporate level strategy, such as providing information on resources and capabilities on which the higher level strategies can be based. Once the higher-level strategy is developed, the functional units translate it into discrete action-plans that each department or division must accomplish for the strategy to succeed.

Horizontal Integration

The acquisition of additional business activities at the same level of the value chain is referred to as **horizontal integration**. This form of expansion contrasts with vertical integration by which the firm expands into upstream or downstream activities. Horizontal growth can be achieved by internal expansion or by external expansion through mergers and acquisitions of firms offering similar products and services. A firm may diversify by growing horizontally into unrelated businesses.

Some examples of horizontal integration include:

- The Standard Oil Company's acquisition of 40 refineries.
- An automobile manufacturer's acquisition of a sport utility vehicle manufacturer.
- A media company's ownership of radio, television, newspapers, books, and magazines.

Advantages of Horizontal Integration

The following are some benefits sought by firms that horizontally integrate:

- Economies of scale - acheived by selling more of the same product, for example, by geographic expansion.
- Economies of scope - achieved by sharing resources common to different products. Commonly referred to as "synergies."
- Increased market power (over suppliers and downstream channel members)
- Reduction in the cost of international trade by operating factories in foreign markets.

Sometimes benefits can be gained through customer perceptions of linkages between products. For example, in some cases synergy can be achieved by using the same brand name to promote multiple products. However, such extensions can have drawbacks, as pointed out by Al Ries and Jack Trout in their marketing classic, *Positioning*.

Pitfalls of Horizontal Integration

Horizontal integration by acquisition of a competitor will increase a firm's market share. However, if the industry concentration increases significantly then anti-trust issues may arise.

Aside from legal issues, another concern is whether the anticipated economic gains will materialize. Before expanding the scope of the firm through horizontal integration, management should be sure that the imagined benefits are real. Many blunders have been made by firms that broadened their horizontal scope to achieve synergies that did not exist, for example, computer hardware manufacturers who entered the software business on the premise that there were synergies between hardware and software. However, a connection between two products does not necessarily imply realizable economies of scope.

Finally, even when the potential benefits of horizontal integration exist, they do not materialize spontaneously. There must be an explicit horizontal strategy in place. Such strategies generally do not arise from the bottom-up, but rather, must be formulated by corporate management.

PEST Analysis

A scan of the external macro-environment in which the firm operates can be expressed in terms of the following factors:

- **P**olitical
- **E**conomic
- **S**ocial
- **T**echnological

The acronym **PEST** (or sometimes rearranged as "STEP") is used to describe a framework for the analysis of these macro environmental factors. A PEST analysis fits into an overall environmental scan as shown in the following diagram:

Environmental Scan

/

\

External Analysis

Internal Analysis

/ \

Macro environment

Microenvironment

|

P.E.S.T.

Political Factors

Political factors include government regulations and legal issues and define both formal and informal rules under which the firm must operate. Some examples include:

- tax policy
- employment laws
- environmental regulations
- trade restrictions and tariffs
- political stability

Economic Factors

Economic factors affect the purchasing power of potential customers and the firm's cost of capital. The following are examples of factors in the macroeconomy:

- economic growth
- interest rates
- exchange rates
- inflation rate

Social Factors

Social factors include the demographic and cultural aspects of the external macro environment. These factors affect customer needs and the size of potential markets. Some social factors include:

- health consciousness
- population growth rate
- age distribution
- career attitudes
- emphasis on safety

Technological Factors

Technological factors can lower barriers to entry, reduce minimum efficient production levels, and influence outsourcing decisions. Some technological factors include:

- R&D activity
- automation
- technology incentives
- rate of technological change

Porter's Five Forces

A MODEL FOR INDUSTRY ANALYSIS

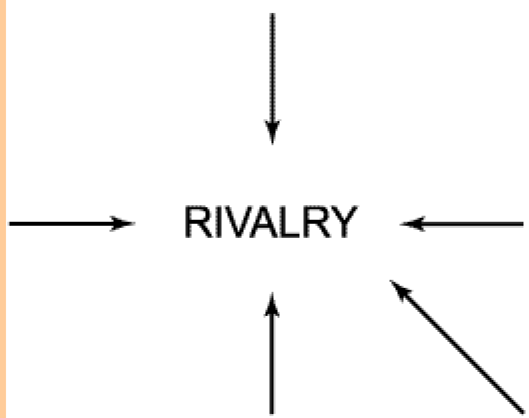
The model of pure competition implies that risk-adjusted rates of return should be constant across firms and industries. However, numerous economic studies have affirmed that different industries can sustain different levels of profitability; part of this difference is explained by industry structure.

Michael Porter provided a framework that models an industry as being influenced by five forces. The strategic business manager seeking to develop an edge over rival firms can use this model to better understand the industry context in which the firm operates.

Diagram of Porter's 5 Forces

SUPPLIER POWER
Supplier concentration
Importance of volume to supplier
Differentiation of inputs
Impact of inputs on cost or differentiation
Switching costs of firms in the industry
Presence of substitute inputs
Threat of forward integration
Cost relative to total purchases in industry

BARRIERS TO ENTRY
Absolute cost advantages
Proprietary learning curve
Access to inputs
Government policy
Economies of scale
Capital requirements
Brand identity
Switching costs
Access to distribution
Expected retaliation
Proprietary products



THREAT OF SUBSTITUTES
-Switching costs
-Buyer inclination to substitute
-Price-performance trade-off of substitutes

BUYER POWER
Bargaining leverage
Buyer volume
Buyer information
Brand identity
Price sensitivity
Threat of backward integration
Product differentiation
Buyer concentration vs. industry
Substitutes available
Buyers' incentives

DEGREE OF RIVALRY
-Exit barriers
-Industry concentration
-Fixed costs/Value added
-Industry growth
-Intermittent overcapacity
-Product differences
-Switching costs
-Brand identity
-Diversity of rivals
-Corporate stakes

I. Rivalry

In the traditional economic model, competition among rival firms drives profits to zero. But competition is not perfect and firms are not unsophisticated passive price takers. Rather, firms strive for a competitive advantage over their rivals. The intensity of rivalry among firms varies across industries, and strategic analysts are interested in these differences.

Economists measure rivalry by indicators of industry concentration. The Concentration Ratio (CR) is one such measure. The Bureau of Census periodically reports the CR for major Standard Industrial Classifications (SIC's). The CR indicates the percent of market share held by the four largest firms (CR's for the largest 8, 25, and 50 firms in an industry also are available). A high concentration ratio indicates that a high concentration of market share is held by the largest firms - the industry is concentrated. With only a few firms holding a large market share, the competitive landscape is less competitive (closer to a monopoly). A low concentration ratio indicates that the industry is characterized by many rivals, none of which has a significant market share. These *fragmented* markets are said to be competitive. The concentration ratio is not the only available measure; the trend is to define industries in terms that convey more information than distribution of market share.

If rivalry among firms in an industry is low, the industry is considered to be disciplined. This discipline may result from the industry's history of competition, the role of a leading firm, or informal compliance with a generally understood code of conduct. Explicit *collusion* generally is illegal and not an option; in low-rivalry industries competitive moves must be constrained informally. However, a maverick firm seeking a competitive advantage can displace the otherwise disciplined market.

When a rival acts in a way that elicits a counter-response by other firms, rivalry intensifies. The intensity of rivalry commonly is referred to as being cutthroat, intense, moderate, or weak, based on the firms' aggressiveness in attempting to gain an advantage.

In pursuing an advantage over its rivals, a firm can choose from several competitive moves:

- Changing prices - raising or lowering prices to gain a temporary advantage.

- Improving product differentiation - improving features, implementing innovations in the manufacturing process and in the product itself.
- Creatively using channels of distribution - using vertical integration or using a distribution channel that is novel to the industry. For example, with high-end jewelry stores reluctant to carry its watches, Timex moved into drugstores and other non-traditional outlets and cornered the low to mid-price watch market.
- Exploiting relationships with suppliers - for example, from the 1950's to the 1970's Sears, Roebuck and Co. dominated the retail household appliance market. Sears set high quality standards and required suppliers to meet its demands for product specifications and price.

The intensity of rivalry is influenced by the following industry characteristics:

1. **A larger number of firms** <u>increases</u> rivalry because more firms must compete for the same customers and resources. The rivalry intensifies if the firms have similar market share, leading to a struggle for market leadership.
2. **Slow market growth** <u>causes firms to fight</u> for market share. In a growing market, firms are able to improve revenues simply because of the expanding market.
3. **High fixed costs** result in an economy of scale effect that <u>increases rivalry</u>. When total costs are mostly fixed costs, the firm must produce near capacity to attain the lowest unit costs. Since the firm must sell this large quantity of product, high levels of production lead to a fight for market share and results in increased rivalry.
4. **High storage costs or highly perishable products** cause a producer to sell goods as soon as possible. If other producers are attempting to unload at the same time, competition for customers intensifies.
5. **Low switching costs** increases rivalry. When a customer can freely switch from one product to another there is a greater struggle to capture customers.
6. **Low levels of product differentiation** is associated with <u>higher levels of rivalry</u>. Brand identification, on the other hand, tends to constrain rivalry.
7. **Strategic stakes are high** when a firm is losing market position or has potential for great gains. This <u>intensifies rivalry</u>.
8. **High exit barriers** place a high cost on abandoning the product. <u>The firm must compete</u>. High exit barriers cause a firm to remain in an industry, even when the venture is not profitable. A common exit barrier is asset specificity. When the plant and equipment required for manufacturing a product is highly specialized, these assets cannot easily be sold to other buyers in another industry. Litton Industries' acquisition of Ingalls Shipbuilding facilities illustrates this concept. Litton was successful in the 1960's with its contracts to

build Navy ships. But when the Vietnam war ended, defense spending declined and Litton saw a sudden decline in its earnings. As the firm restructured, divesting from the shipbuilding plant was not feasible since such a large and highly specialized investment could not be sold easily, and Litton was forced to stay in a declining shipbuilding market.

9. **A diversity of rivals** with different cultures, histories, and philosophies make an industry unstable. There is greater possibility for mavericks and for misjudging rival's moves. <u>Rivalry is volatile</u> and can be intense. The hospital industry, for example, is populated by hospitals that historically are community or charitable institutions, by hospitals that are associated with religious organizations or universities, and by hospitals that are for-profit enterprises. This mix of philosophies about mission has lead occasionally to fierce local struggles by hospitals over who will get expensive diagnostic and therapeutic services. At other times, local hospitals are highly cooperative with one another on issues such as community disaster planning.

10. **Industry Shakeout.** A growing market and the potential for high profits induces new firms to enter a market and incumbent firms to increase production. A point is reached where the industry becomes crowded with competitors, and demand cannot support the new entrants and the resulting increased supply. The industry may become crowded if its growth rate slows and the market becomes saturated, creating a situation of excess capacity with too many goods chasing too few buyers. A shakeout ensues, with intense competition, price wars, and company failures.

    BCG founder Bruce Henderson generalized this observation as the Rule of Three and Four: a stable market will not have more than three significant competitors, and the largest competitor will have no more than four times the market share of the smallest. If this rule is true, it implies that:

    - If there is a larger number of competitors, a shakeout is inevitable
    - Surviving rivals will have to grow faster than the market
    - Eventual losers will have a negative cash flow if they attempt to grow
    - All except the two largest rivals will be losers
    - The definition of what constitutes the "market" is strategically important.

Whatever the merits of this rule for stable markets, it is clear that market stability and changes in supply and demand affect rivalry. Cyclical demand tends to create cutthroat competition. This is true in the disposable diaper industry in which demand fluctuates with birth rates, and in the greeting card industry in which there are more predictable business cycles.

II. Threat of Substitutes

In Porter's model, substitute products refer to products in other industries. To the economist, a threat of substitutes exists when a product's demand is affected by the price change of a substitute product. A product's price elasticity is affected by substitute products - as more substitutes become available, the demand becomes more elastic since customers have more alternatives. A close substitute product constrains the ability of firms in an industry to raise prices.

The competition engendered by a Threat of Substitute comes from products outside the industry. The price of aluminum beverage cans is constrained by the price of glass bottles, steel cans, and plastic containers. These containers are substitutes, yet they are not rivals in the aluminum can industry. To the manufacturer of automobile tires, tire retreads are a substitute. Today, new tires are not so expensive that car owners give much consideration to retreading old tires. But in the trucking industry new tires are expensive and tires must be replaced often. In the truck tire market, retreading remains a viable substitute industry. In the disposable diaper industry, cloth diapers are a substitute and their prices constrain the price of disposables.

While the treat of substitutes typically impacts an industry through price competition, there can be other concerns in assessing the threat of substitutes. Consider the substitutability of different types of TV transmission: local station transmission to home TV antennas via the airways versus transmission via cable, satellite, and telephone lines. The new technologies available and the changing structure of the entertainment media are contributing to competition among these substitute means of connecting the home to entertainment. Except in remote areas it is unlikely that cable TV could compete with free TV from an aerial without the greater diversity of entertainment that it affords the customer.

III. Buyer Power

The power of buyers is the impact that customers have on a producing industry. In general, when buyer power is strong, the relationship to the producing industry is near to what an economist terms a **monopsony** - a market in which there are many suppliers and one buyer. Under such market conditions, the buyer sets the price. In reality few pure monopsonies exist, but frequently there is some asymmetry between a producing industry and buyers. The following tables outline some factors that determine buyer power.

IV. Supplier Power

A producing industry requires raw materials - labor, components, and other supplies. This requirement leads to buyer-supplier relationships between the industry and the firms that provide it the raw materials used to create products. Suppliers, if powerful, can exert an influence on the producing industry, such as selling raw materials at a high price to capture some of the industry's profits. The following tables outline some factors that determine supplier power.

V. Barriers to Entry / Threat of Entry

It is not only incumbent rivals that pose a threat to firms in an industry; the possibility that new firms may enter the industry also affects competition. In theory, any firm should be able to enter and exit a market, and if free entry and exit exists, then profits always should be nominal. In reality, however, industries possess characteristics that protect the high profit levels of firms in the market and inhibit additional rivals from entering the market. These are ***barriers to entry***.

Barriers to entry are more than the normal equilibrium adjustments that markets typically make. For example, when industry profits increase, we would expect additional firms to enter the market to take advantage of the high profit levels, over time driving down profits for all firms in the industry. When profits decrease, we would expect some firms to exit the market thus restoring a market equilibrium. Falling prices, or the expectation that future prices will fall, deters rivals from entering a market. Firms also may be reluctant to enter markets that are extremely uncertain, especially if entering involves expensive start-up costs. These are normal accommodations to market conditions. But if firms individually (collective action would be illegal collusion) keep prices artificially low as a strategy to prevent potential entrants from entering the market, such **entry-deterring pricing** establishes a barrier.

Barriers to entry are unique industry characteristics that define the industry. Barriers reduce the rate of entry of new firms, thus maintaining a level of profits for those already in the industry. From a strategic perspective, barriers can be created or exploited to enhance a firm's competitive advantage. Barriers to entry arise from several sources:

1. **Government creates barriers.** Although the principal role of the government in a market is to preserve competition through anti-trust actions, government also restricts competition through the granting of monopolies and through regulation. Industries such as utilities are considered natural monopolies because it has been more efficient to have one electric company provide power to a locality than to permit many electric companies to compete in a local market. To restrain utilities from exploiting this advantage, government permits a monopoly, but regulates the industry. Illustrative of this kind of barrier to entry is the local cable company. The franchise to a cable provider may be granted by competitive bidding, but once the franchise is awarded by a community a monopoly is created. Local governments were not effective in monitoring price gouging by cable operators, so the federal government has enacted legislation to review and restrict prices.

   The regulatory authority of the government in restricting competition is historically evident in the banking industry. Until the 1970's, the markets that banks could enter were limited by state governments. As a result, most banks were local commercial and retail banking facilities. Banks competed through strategies that emphasized simple marketing devices such as awarding toasters to new customers for opening a checking account. When banks were deregulated, banks were permitted to cross state boundaries and expand their markets. Deregulation of banks intensified rivalry and created uncertainty for banks as they attempted to maintain market share. In the late 1970's, the strategy of banks shifted from simple marketing tactics to mergers and geographic expansion as rivals attempted to expand markets.

2. **Patents and proprietary knowledge serve to restrict entry into an industry.** Ideas and knowledge that provide competitive advantages are treated as private property when patented, preventing others from using the knowledge and thus creating a barrier to entry. Edwin Land introduced the Polaroid camera in 1947 and held a monopoly in the instant photography industry. In 1975, Kodak attempted to enter the instant camera market and sold a comparable camera. Polaroid sued for patent infringement and won, keeping Kodak out of the instant camera industry.
3. **Asset specificity inhibits entry into an industry.** Asset specificity is the extent to which the firm's assets can be utilized to produce a different product.

When an industry requires highly specialized technology or plants and equipment, potential entrants are reluctant to commit to acquiring specialized assets that cannot be sold or converted into other uses if the venture fails. Asset specificity provides a barrier to entry for two reasons: First, when firms already hold specialized assets they fiercely resist efforts by others from taking their market share. New entrants can anticipate aggressive rivalry. For example, Kodak had much capital invested in its photographic equipment business and aggressively resisted efforts by Fuji to intrude in its market. These assets are both large and industry specific. The second reason is that potential entrants are reluctant to make investments in highly specialized assets.

4. **Organizational (Internal) Economies of Scale.** The most cost efficient level of production is termed **Minimum Efficient Scale** (MES). This is the point at which unit costs for production are at minimum - i.e., the most cost efficient level of production. If MES for firms in an industry is known, then we can determine the amount of market share necessary for low cost entry or cost parity with rivals. For example, in long distance communications roughly 10% of the market is necessary for MES. If sales for a long distance operator fail to reach 10% of the market, the firm is not competitive.

   The existence of such an economy of scale creates a barrier to entry. The greater the difference between industry MES and entry unit costs, the greater the barrier to entry. So industries with high MES deter entry of small, start-up businesses. To operate at less than MES there must be a consideration that permits the firm to sell at a premium price - such as product differentiation or local monopoly.

Barriers to exit work similarly to barriers to entry. Exit barriers limit the ability of a firm to leave the market and can exacerbate rivalry - unable to leave the industry, a firm must compete. Some of an industry's entry and exit barriers can be summarized as follows:

Easy to Enter if there is:	**Difficult to Enter if there is:**
• Common technology • Little brand franchise	• Patented or proprietary know-how • Difficulty in brand switching

• Access to distribution channels • Low scale threshold	• Restricted distribution channels • High scale threshold
Easy to Exit if there are: • Salable assets • Low exit costs • Independent businesses	**Difficult to Exit if there are:** • Specialized assets • High exit costs • Interrelated businesses

DYNAMIC NATURE OF INDUSTRY RIVALRY

Our descriptive and analytic models of industry tend to examine the industry at a given state. The nature and fascination of business is that it is not static. While we are prone to generalize, for example, list GM, Ford, and Chrysler as the "Big 3" and assume their dominance, we also have seen the automobile industry change. Currently, the entertainment and communications industries are in flux. Phone companies, computer firms, and entertainment are merging and forming strategic alliances that re-map the information terrain. Schumpeter and, more recently, Porter have attempted to move the understanding of industry competition from a static economic or industry organization model to an emphasis on the interdependence of forces as dynamic, or *punctuated equilibrium*, as Porter terms it.

In Schumpeter's and Porter's view the dynamism of markets is driven by innovation. We can envision these forces at work as we examine the following changes: