LEARNING OBJECTIVES

1. To gain command of the basic concepts and analytical tools widely used to diagnose a company’s industry and competitive conditions.
2. To become adept at recognizing the factors that cause competition in an industry to be fierce, more or less normal, or relatively weak.
3. To learn how to determine whether an industry’s outlook presents a company with sufficiently attractive opportunities for growth and profitability.
4. To understand why in-depth evaluation of specific industry and competitive conditions is a prerequisite to crafting a strategy well matched to a company’s situation.
In the opening paragraph of Chapter 1, we said that one of the three central questions that managers must address in evaluating their company’s business prospects is “What’s the company’s present situation?” Two facets of a company’s situation are especially pertinent: (1) the industry and competitive environment in which the company operates and (2) the company’s collection of resources and capabilities, its strengths and weaknesses vis-à-vis rivals, and its windows of opportunity.

Insightful analysis of a company’s external and internal environment is a prerequisite for crafting a strategy that is an excellent fit with the company’s situation, is capable of building competitive advantage, and holds good prospect for boosting company performance—the three criteria of a winning strategy.

As depicted in Figure 3.1, the task of crafting a company’s strategy should always begin with appraisals of the company’s external environment and internal environment (as a basis for deciding on a long-term strategic direction and developing a strategic vision), then proceed to an evaluation of the most promising alternative strategic options and business models, and culminate in choosing a specific strategy.

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 a company operates, the drivers of market change, and rival companies’ actions. In Chapter 4 we explore the methods of evaluating a company’s internal circumstances and competitiveness.
THE STRATEGICALLY RELEVANT COMPONENTS OF A COMPANY’S EXTERNAL ENVIRONMENT

All companies operate in a macroenvironment shaped by influences emanating from general economic conditions; population demographics; societal values and lifestyles; legislation and regulations; technology; and, closer to home, the industry and competitive environment in which the company operates (see Figure 3.2). Strictly speaking, a company’s macroenvironment includes all relevant factors and influences outside the company’s boundaries; by relevant, we mean important enough to have a bearing on the decisions the company ultimately makes about its direction, objectives, strategy, and business model. Strategically relevant influences coming from the outer ring of the macroenvironment can sometimes have a high impact on a company’s business situation and have a very significant impact on the company’s direction and strategy. The strategic opportunities of cigarette producers to grow their business are greatly reduced by antismoking ordinances and the growing cultural stigma attached to smoking. Motor vehicle companies must adapt their strategies (especially as concerns the fuel mileage of their vehicles) to customer concerns about gasoline prices. The demographics of an aging population and longer life expectancies are having a dramatic impact on the business prospects and strategies of health care and prescription drug companies. Companies in most all industries have to craft strategies that are responsive to environmental regulations, growing use of the Internet, and energy prices. Companies in the food processing, restaurant, sports, and fitness industries have to pay special attention to changes in lifestyles, eating habits, leisure-time preferences, and attitudes toward nutrition and fitness in fashioning their strategies.
Happenings in the outer ring of the macroenvironment may occur rapidly or slowly, with or without advance warning. The impact of outer-ring factors on a company’s choice of strategy can range from big to small. But even if the factors in the macroenvironment change slowly or affect a company’s situation only modestly, there are enough strategically relevant outer-ring trends and events to justify a watchful eye. 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 macroenvironment having the biggest strategy-shaping impact typically pertain to the company’s immediate industry and competitive environment—the actions of rivals firms, buyer behavior, supplier-related considerations, and so on. Consequently, it is on a company’s industry and competitive environment that we concentrate our attention in this chapter.
THINKING STRATEGICALLY ABOUT A COMPANY'S INDUSTRY AND COMPETITIVE ENVIRONMENT

To gain a deep understanding of a company’s industry and competitive environment, managers do not need to gather all the information they can find and spend lots of time digesting it. Rather, the task is much more focused. Thinking strategically about a company’s industry and competitive environment entails using some well-defined concepts and analytical tools to get clear answers to seven questions:

1. What are the industry’s dominant economic features?
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 for future competitive success?
7. Does the outlook for the industry offer the company a good opportunity to earn attractive profits?

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

QUESTION 1: WHAT ARE THE INDUSTRY’S DOMINANT ECONOMIC FEATURES?

Because industries differ so significantly, analyzing a company’s industry and competitive environment begins with identifying an industry’s dominant economic features and gaining an an accurate and insightful view of the industry landscape. An industry’s dominant economic features are defined by such factors as market size and growth rate, the number and sizes of buyers and sellers, the geographic boundaries of the market (which can extend from local to worldwide), whether sellers’ products are virtually identical or highly differentiated, the pace of technological change, and the extent of vertical integration. Table 3.1 provides a convenient summary of what economic features to look at and the corresponding questions to consider in profiling an industry’s landscape.

Getting a handle on an industry’s distinguishing economic features not only allows managers to prepare for the analysis to come but also helps them understand the kinds of strategic moves that industry members are likely to employ. For example, in industries characterized by one product advance after another—such as the video game, computer, and pharmaceuticals industries—companies must invest in research and development (R&D) and maintain strong product innovation capabilities. An industry that has recently passed through the rapid-growth stage and is looking at single-digit percentage increases
Table 3.1  What to Consider in Identifying an Industry’s Dominant Economic Features

<table>
<thead>
<tr>
<th>Economic Feature</th>
<th>Questions to Answer</th>
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<tbody>
<tr>
<td>Market size and growth rate</td>
<td>• How big is the industry and how fast is it growing?</td>
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<tr>
<td></td>
<td>• What does the industry’s position in the product life cycle (early development, rapid growth and takeoff, early maturity and slowing growth, saturation and stagnation, decline) reveal about the industry’s growth prospects?</td>
</tr>
<tr>
<td>Number of rivals</td>
<td>• Is the industry fragmented into many small companies or concentrated and dominated by a few large companies?</td>
</tr>
<tr>
<td></td>
<td>• Is the industry consolidating to a smaller number of competitors?</td>
</tr>
<tr>
<td>Scope of competitive rivalry</td>
<td>• Is the geographic area over which most companies compete local, regional, national, multinational, or global?</td>
</tr>
<tr>
<td></td>
<td>• Is having a presence in foreign markets becoming more important to a company’s long-term competitive success?</td>
</tr>
<tr>
<td>Number of buyers</td>
<td>• Is market demand fragmented among many buyers?</td>
</tr>
<tr>
<td></td>
<td>• Do some buyers have bargaining power because they purchase in large volume?</td>
</tr>
<tr>
<td>Degree of product differentiation</td>
<td>• Are the products of rivals becoming more differentiated or less differentiated?</td>
</tr>
<tr>
<td></td>
<td>• Are the products of rivals becoming increasingly similar and causing heightened price competition?</td>
</tr>
<tr>
<td>Product innovation</td>
<td>• Is the industry characterized by rapid product innovation and short product life cycles?</td>
</tr>
<tr>
<td></td>
<td>• How important is R&amp;D and product innovation?</td>
</tr>
<tr>
<td></td>
<td>• Are there opportunities to overtake key rivals by being first-to-market with next-generation products?</td>
</tr>
<tr>
<td>Demand–supply conditions</td>
<td>• Is a surplus of capacity pushing prices and profit margins down?</td>
</tr>
<tr>
<td></td>
<td>• Is the industry overcrowded with competitors?</td>
</tr>
<tr>
<td>Pace of technological change</td>
<td>• What role does advancing technology play in this industry?</td>
</tr>
<tr>
<td></td>
<td>• Are ongoing upgrades of facilities/equipment essential because of rapidly advancing production process technologies?</td>
</tr>
<tr>
<td></td>
<td>• Do most industry members have or need strong technological capabilities? Why?</td>
</tr>
<tr>
<td>Vertical integration</td>
<td>• Do most competitors operate in only one stage of the industry (parts and components production, manufacturing and assembly, distribution, retailing), or do some competitors operate in multiple stages?</td>
</tr>
<tr>
<td></td>
<td>• Is there any cost or competitive advantage or disadvantage associated with being fully or partially integrated?</td>
</tr>
<tr>
<td>Economies of scale</td>
<td>• Is the industry characterized by economies of scale in purchasing, manufacturing, advertising, shipping, or other activities?</td>
</tr>
<tr>
<td></td>
<td>• Do companies with large-scale operations have an important cost advantage over small-scale firms?</td>
</tr>
<tr>
<td>Learning/experience curve effects</td>
<td>• Are certain industry activities characterized by strong learning and experience effects (“learning by doing”) such that unit costs decline as a company’s experience in performing the activity builds?</td>
</tr>
<tr>
<td></td>
<td>• Do any companies have significant cost advantages because of their learning/experience in performing particular activities?</td>
</tr>
</tbody>
</table>
in buyer demand is likely to be experiencing a competitive shake-out and much stronger strategic emphasis on cost reduction and improved customer service.

In industries like semiconductors, strong learning/experience effects in manufacturing cause unit costs 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, the unit cost would drop to $80 (80 percent of $100) when production volume reaches 2 million and then drop further to $64 (80 percent of $80) when production volume reaches 4 million. The bigger the learning or experience curve effect, the bigger the cost advantage of the company with the largest cumulative production volume. Thus, when an industry is characterized by important learning/experience curve effects (or by economies of scale), industry members are strongly motivated to adopt volume-increasing strategies to capture the resulting cost-saving economies and maintain their competitiveness. Unless small-scale firms succeed in pursuing strategic options that allow them to grow sales sufficiently to remain cost-competitive with larger-volume rivals, they are unlikely to survive. The bigger the learning/experience curve effects and/or scale economies in an industry, the more imperative it becomes for competing sellers to pursue strategies to win additional sales and market share—the company with the biggest sales volume gains sustainable competitive advantage as the low-cost producer.

**QUESTION 2: HOW STRONG ARE COMPETITIVE FORCES?**

Competitive forces are never the same from one industry to another. Far and away the most powerful and widely used tool for systematically diagnosing the principal competitive pressures in a market and assessing the strength and importance of each is the five-forces model of competition. This model, depicted in Figure 3.3, holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

1. Competitive pressures associated with the market maneuvering and jockeying for buyer patronage that goes on among rival sellers in the industry.
2. Competitive pressures associated with the threats of new entrants.
3. Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own substitute products.
4. Competitive pressures stemming from supplier bargaining power and supplier–seller collaboration.
5. Competitive pressures stemming from buyer bargaining power and seller–buyer collaboration.

The way one uses the five-forces model to determine the makeup and strength of competitive pressures in a given industry is to build the picture of competitive landscape in three steps:

- **Step 1:** Identify the specific competitive pressures associated with each of the five forces.
- **Step 2:** Evaluate how strong the pressures comprising each of the five forces are (fierce, strong, moderate to normal, or weak).
- **Step 3:** Determine whether the collective strength of the five competitive forces is conducive to earning attractive profits.
Competitive Pressures Created by the Rivalry among Competing Sellers

The strongest of the five competitive forces is nearly always the market maneuvering for buyer patronage that goes on among rival sellers of a product or service. In effect, a market is a competitive battlefield where there’s no end to the maneuvering for buyer patronage. Rival sellers employ whatever weapons they have in their business arsenal to strengthen their market positions, attract and retain buyers, and earn good profits.
The challenge for company managers is to craft a competitive strategy that, at the very least, allows the company to hold its own against rivals and that, ideally, produces a competitive edge. 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, shifting their strategic emphasis from one combination of product attributes, marketing tactics, and capabilities to another. This pattern of action and reaction, move and countermove, adjustment and readjustment produces a continually evolving competitive landscape where the market battle ebbs and flows, sometimes takes unpredictable twists and turns, and produces winners and losers. But the winners—the current market leaders—have no guarantees of continued leadership; their market success is no more durable than the power of their strategies to fend off the strategies of ambitious challengers. In every industry, the ongoing maneuvering of rivals leads to one or another company gaining or losing momentum in the marketplace according to whether their latest strategic actions succeed or fail.  

Figure 3.4 shows a sampling of competitive weapons that firms can deploy in battling rivals and indicates the factors that influence the intensity of their rivalry. A brief discussion of the principal factors that influence the tempo of rivalry among industry competitors is in order:

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

Normally, competitive jockeying among rival sellers is active and fairly intense because competing companies are highly motivated to launch whatever fresh actions and creative market maneuvers they can think of to try to strengthen their market positions and business performance.

- **Rivalry is usually stronger when buyer demand is growing slowly and weaker when buyer demand is growing rapidly.** Rapidly expanding buyer demand...
• Competing sellers are active in making fresh moves to improve their market standing and business performance.
• Buyer demand is growing slowly.
• Buyer demand falls off and sellers find themselves with excess capacity and/or inventory.
• The number of rivals increases and rivals are of roughly equal size and competitive capability.
• Buyer costs to switch brands are low.
• The products of rival sellers are commodities or else weakly differentiated.
• One or more rivals are dissatisfied with their current position and market share and make aggressive moves to attract more customers.
• Rivals have diverse objectives and strategies and/or are located in different countries.
• Outsiders have recently acquired weak competitors and are trying to turn them into major contenders.
• One or two rivals have powerful strategies and other rivals are scrambling to stay in the game.

Typical “Weapons” for Battling Rivals and Attracting Buyers
• Lower prices.
• More or different features.
• Better product performance.
• Higher quality.
• Stronger brand image and appeal.
• Wider selection of models and styles.
• Bigger/better dealer network.
• Low-interest financing.
• Higher levels of advertising.
• Stronger product innovation capabilities.
• Better customer service capabilities.
• Stronger capabilities to provide buyers with custom-made products.

Rivalry among Competing Sellers
How strong are the competitive pressures stemming from the efforts of rivals to gain better market positions, higher sales and market shares, and competitive advantages?

Rivalry is generally stronger when:
• Industry members move only infrequently or in a nonaggressive manner to draw sales and market share away from rivals.
• Buyer demand is growing rapidly.
• The products of rival sellers are strongly differentiated and customer loyalty is high.
• Buyer costs to switch brands are high.
• There are fewer than 5 sellers or else so many rivals that any one company’s actions have little direct impact on rivals’ business.

produces enough new business for all industry members to grow. But in markets where growth is sluggish or where buyer demand drops off unexpectedly, expansion-minded firms and/or firms with excess capacity often are quick to cut prices and initiate other sales-increasing tactics, thereby igniting a battle for market share that can threaten the survival of competitively weak firms.

• Rivalry increases when buyer demand falls off and sellers find themselves with excess capacity and/or inventory. Excess supply conditions create a “buyer’s market,” putting added competitive pressure on industry rivals to scramble for profitable
sales levels. When a product is perishable, seasonal, or costly to hold in inventory, competitive pressures build quickly anytime 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. Unused capacity imposes a significant cost-increasing penalty, because there are fewer units over which to spread fixed costs. The pressure of high fixed costs can push rival firms into price concessions, special discounts, rebates, low-interest-rate financing, and other volume-boosting tactics.

- **Rivalry is stronger in industries where the number of rivals increases and 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 must compete aggressively to hold their own in the industry.

- **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. But the higher the costs associated with switching brands, the less prone buyers are to make the switch. Abandoning a familiar brand may entail added time, inconvenience, or psychological costs.

- **Rivalry increases as it becomes less costly for buyers to switch brands and diminishes as buyer switching costs increase.** 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. But the higher the costs buyers incur to switch brands, the less prone they are to brand switching. Even if consumers view one or more rival brands as more attractive, they may not be inclined to switch because of the added time and inconvenience that may be involved or the psychological costs of abandoning a familiar brand. Distributors and retailers may not switch to the brands of rival manufacturers because they are hesitant to sever longstanding supplier relationships, incur any technical support costs or retraining expenses in making the switchover, go to the trouble of testing the quality and reliability of the rival brand, or devote resources to marketing the new brand (especially if the brand is lesser-known). Apple Computer, for example, has long had to struggle to convince PC users to switch from Windows-based PCs because of the time burdens and inconvenience associated with learning Apple’s operating system and because so many Windows-based applications will not run on a MacIntosh due to operating system incompatibility. In short, unless buyers are dissatisfied with the brand they are presently purchasing, high switching costs can significantly weaken the rivalry among competing sellers.

- **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 convince buyers to switch to their offering. And since the brands of different sellers have comparable attributes, buyers can shop the market for the best deal and switch brands at will. On the other hand, strongly differentiated product offerings among rivals breed
high brand loyalty on the part of buyers—because many buyers view the attributes of certain brands as better suited to their needs. Strong brand attachments make it tougher for sellers to draw customers away from rivals. Unless meaningful numbers of buyers are open to considering new or different product attributes being offered by rivals, the high degree of brand loyalty that accompanies strong product differentiation works against fierce rivalry among competing sellers.

- **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 anytime 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. Unused capacity imposes a significant cost-increasing penalty because there are fewer units over which to spread fixed costs. The pressure of high fixed costs can push rival firms into price concessions, special discounts, rebates, low-interest-rate financing, and other volume-boosting tactics.

- **Rivalry increases when one or more competitors become dissatisfied with their market position.** Firms that are losing ground or in financial trouble often initiate aggressive (perhaps even 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 becomes more volatile and unpredictable as the diversity of competitors increases in terms of visions, strategic intents, objectives, strategies, resources, and countries of origin.** A diverse group of sellers often contains one or more mavericks willing to try novel or rule-breaking market approaches, thus generating a livelier and less predictable competitive environment. Globally competitive markets usually boost the intensity of rivalry, especially when aggressors having lower costs or products with more attractive features are intent on gaining a strong foothold in new country markets.

- **Rivalry increases when strong companies outside the industry acquire weak firms in the industry and launch aggressive, well-funded moves to transform their newly acquired competitors into major market contenders.** 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.

- **When one or two companies employ powerful, successful competitive strategies, the competitive pressures on other industry members intensify significantly.** Industry members that suddenly start to lose sales and market share to offensive-minded competitors may have to scramble to stay in the game; they either have to launch effective strategic responses (which further intensifies rivalry) or be relegated to also-ran status.

- **Rivalry is usually weaker in industries made up of vast numbers of small rivals; likewise, it is often weak when there are fewer than five competitors.** When an industry is populated with so many rivals that the impact of successful moves by any one company ripple out to have little discernible impact on the businesses of its many rivals, then head-to-head rivalry turns out to be relatively weak—industry members soon learn that it is not imperative to respond every time one or another
rival does something to enhance its market position. Rivalry also tends to be weak if an industry consists of just two to four sellers because each competitor soon learns that aggressive moves to grow its sales and market share have immediate adverse impact on rivals’ businesses and will almost certainly provoke vigorous retaliation. Hence, there is a tendency for competition among the few to produce a live-and-let-live approach to competing because rivals see the merits of restrained efforts to wrest sales and market share from competitors as opposed to undertaking hard-hitting offensives that escalate into a profit-eroding arms race or price war. 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 Linux and Microsoft in operating system software and between Intel and AMD in microprocessors for PCs and servers and the decades-long war between Coca-Cola and Pepsi are prime examples.

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 content with their sales growth and market shares, rarely undertake offensives to steal customers away from one another, and have comparatively attractive earnings and returns on investment.

**Competitive Pressures Associated with the Threat of New Entrants**

Several factors determine whether the threat of new companies entering the marketplace poses significant competitive pressure (see Figure 3.5). One factor relates to the size of the pool of likely entry candidates. As a rule, the bigger the pool of entry candidates, the stronger is the threat of potential entry. 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. Companies already well established in certain product categories or geographic areas often possess the resources, competencies, and competitive capabilities to hurdle the barriers of entering a different market segment or new geographic area.

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:

- **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**—Industry incumbents can have cost advantages that stem from experience/learning curve
effects, the possession of proprietary technology, partnerships with the best and cheapest suppliers, and low fixed costs (because they have older facilities that have been mostly depreciated).

- **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. In such cases, a new entrant must have the financial resources to spend enough on advertising and sales promotion to overcome customer loyalties and build its own clientele. Establishing brand recognition and building customer loyalty can be a slow and costly process. In addition, if it is difficult or costly for a customer to switch to a new brand, a new entrant must persuade buyers that its brand is worth the switching costs. To overcome switching-cost barriers, new entrants may have to offer buyers a discounted price or an extra margin of quality or service. Such barriers discourage new entry because they act to boost financial requirements and lower expected profit margins for new entrants.

- **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 distributor/retailer network 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. It may be hard to recruit retailers and convince them 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—that restricts the pool of entry candidates to companies with deep enough financial pockets to take on the challenges of building a viable network of distributors and retailers.

- *Restrictive regulatory policies*—Government agencies can limit or even bar entry by requiring licenses and permits. Regulated industries like cable TV, telecommunications, electric and gas utilities, and radio and television broadcasting are characterized by government-controlled entry. Stringent government-mandated safety regulations and environmental pollution standards raise entry costs.

- *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. 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 customer high monthly rates for cable Internet access.

Whether an industry’s entry barriers ought to be considered high or low depends on the resources and competencies possessed by the pool of potential entrants. Companies with sizable financial resources, proven competitive capabilities, and a respected brand name may be able to hurdle an industry’s entry barriers rather easily. Small start-up enterprises may find the same entry barriers insurmountable. When Honda opted to enter the U.S. lawn-mower market in competition against Toro, Snapper, Craftsman, John Deere, and others, it was easily able to hurdle entry barriers that would have been formidable to other newcomers because it had long-standing expertise in gasoline engines and because its well-known reputation for quality and durability gave it instant credibility with homeowners. Honda had to spend relatively little on advertising to attract buyers and gain a market foothold, distributors and dealers were quite willing to handle the Honda lawn-mower line, and Honda had ample capital to build a U.S. assembly plant.
In evaluating whether the threat of additional entry is strong or weak, company managers must also look at how attractive the growth and profit prospects are for new entrants. Rapidly growing market demand and high potential profits act as magnets, motivating potential entrants to commit the resources needed to hurdle entry barriers. When growth and profit opportunities are sufficiently attractive, entry barriers are unlikely to be an effective entry deterrent. The best test of whether potential entry is a strong or weak competitive force in the marketplace is to ask if the industry’s growth and profit prospects are strongly attractive to potential entry candidates. The stronger the threat of entry, the more that incumbent firms must seek ways to fortify their positions against newcomers and make entry more costly or difficult.

One additional point: The threat of entry changes as the industry’s prospects grow brighter or dimmer and as entry barriers rise or fall. For example, in the pharmaceutical industry the expiration of a key patent on a widely prescribed drug virtually guarantees that one or more drug makers will enter with generic offerings of their own. Use of the Internet for shopping is making it much easier for e-tailers to enter into competition against some of the best-known retail chains. In international markets, entry barriers for foreign-based firms fall as tariffs are lowered, as host governments open up their domestic markets to outsiders, as domestic wholesalers and dealers seek out lower-cost foreign-made goods, and as domestic buyers become more willing to purchase foreign brands.

### Competitive Pressures from the Sellers of Substitute Products

Companies in one industry come under competitive pressure from the actions of companies in a closely adjoining industry whenever buyers view the products of the two industries as good substitutes. For instance, the producers of sugar experience competitive pressures from the sales and marketing efforts of the makers of Equal, Splenda, and Sweet’N Low. Similarly, the producers of eyeglasses and contact lenses face competitive pressures from doctors who do corrective laser surgery. The makers of disc-based music players are facing such stiff competition from Apple’s iPod and other brands of MP3 players that devices whose chief purpose is to play of music CDs and DVDs are fast becoming obsolete. Newspapers are struggling to maintain their relevance to subscribers who can readily turn to cable news channels for late-breaking news and use Internet sources to get information about sports results, stock quotes, and job opportunities. First-run movie theater chains are feeling competitive heat as consumers are staying home to watch movies on their big-screen, high-definition TVs, using either DVDs or movies-on-demand services. The producers of metal cans are becoming increasingly engaged in a battle with the makers of retort pouches (multilayer packages made from polypropylene, aluminum foil, or polyester) for the business of companies producing packaged fruits, vegetables, meats, and pet foods. Retort pouches are more attractively priced than metal cans because they are less expensive to produce and ship.

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 being 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 for film cameras not only because digital cameras are easy to use but also because they allow people to download images to a home computer and delete bad shots without paying for film developing. Competition from good-performing substitutes unleashes competitive pressures on industry participants to incorporate new performance features and attributes that makes their product offerings more competitive.

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 3.6 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. Other market indicators of the competitive strength of substitute products include (1) whether the sales of substitutes are growing faster than the sales of the industry being analyzed (a sign that the sellers of substitutes may be drawing customers away from the industry in question), (2) whether the producers of substitutes are moving to add new capacity, and (3) whether the profits of the producers of substitutes are on the rise.

**Competitive Pressures Stemming from Supplier Bargaining Power and Supplier–Seller Collaboration**

Whether supplier–seller relationships represent a weak competitive force or a strong one depends on (1) whether the major suppliers can exercise sufficient bargaining power to influence the terms and conditions of supply in their favor, and (2) how closely one or more industry members collaborate with their suppliers to achieve supply chain efficiencies.

**How Supplier Bargaining Power Can Create Competitive Pressures**

Sometimes the actions of important suppliers bring competitive pressures to bear on the companies they are supplying. For instance, Microsoft and Intel, both of whom supply PC makers with products that most PC users consider essential, are known for using their dominant market status not only to charge PC makers premium prices but also to leverage PC makers in other ways. Microsoft pressures PC makers to position the icons for Microsoft software prominently on the screens of new computers that come with factory-loaded software. Intel tends to give PC makers who 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 allocation of the first production runs of Intel’s latest and greatest chips and thus get new PC models to market ahead of rivals. The ability of Microsoft and Intel...
Small-scale retailers must often contend with the power of manufacturers whose products enjoy prestigious and well-respected brand names; when a manufacturer knows that a retailer needs to stock the manufacturer’s product because consumers expect to find the product on the shelves of retail stores where they shop, the manufacturer usually has some degree of pricing power and may even be able to push hard for favorable shelf displays. Motor vehicle manufacturers typically exert considerable power over the terms and conditions with which they supply new vehicles to their independent automobile dealerships. The operators of franchised units of such chains as McDonald’s, Dunkin’ Donuts, Pizza Hut, Sylvan Learning Centers, and Hampton Inns must frequently agree not only to source some of their supplies from the franchisor at prices and terms favorable to that franchisor but also to operate their facilities in a manner largely dictated by the franchisor.
Strong supplier bargaining power is also a competitive factor in industries where unions have been able to organize the workforces of some industry members but not others; those industry members that must negotiate wages, fringe benefits, and working conditions with powerful unions (which control the supply of labor) often find themselves with higher labor costs than their competitors with nonunion labor forces. The bigger the gap between union and nonunion labor costs in an industry, the more that unionized industry members must scramble to find ways to relieve the competitive pressure associated with their labor cost disadvantage. High labor costs are proving a huge competitive liability to unionized supermarket chains like Kroger and Safeway in trying to combat the market share gains being made by Wal-Mart in supermarket retailing—at Wal-Mart Supercenters, the prices for supermarket items tend to run 5 to 20 percent lower than those at unionized supermarket chains.

The factors that determine whether any of the suppliers to an industry are in a position to exert substantial bargaining power or leverage are fairly clear-cut: 10

1. Whether the item being supplied is a commodity that is readily available from many suppliers at the going market price. Suppliers have little or no bargaining power or leverage whenever industry members have the ability to source their requirements at competitive prices from any of several alternative and eager suppliers, perhaps dividing their purchases among two or more suppliers to promote lively competition for orders. The suppliers of commodity items have market power only when supplies become quite tight and industry members are so eager to secure what they need that they agree to terms more favorable to suppliers.

2. Whether a few large suppliers are the primary sources of a particular item. The leading suppliers may well have pricing leverage unless they are plagued with excess capacity and are scrambling to secure additional orders for their products. Companies find it harder to wring concessions from major suppliers with good reputations and strong demand than from struggling suppliers striving to broaden their customer base or more fully utilize their production capacity.

3. Whether it is difficult or costly for industry members to switch their purchases from one supplier to another or to switch to attractive substitute inputs. High switching costs signal strong bargaining power on the part of suppliers, whereas low switching costs and ready availability of good substitute inputs signal weak bargaining power. Soft drink bottlers, for example, can counter the bargaining power of aluminum can suppliers by shifting or threatening to shift to greater use of plastic containers and introducing more attractive plastic container designs.

4. Whether certain needed inputs are in short supply. Suppliers of items in short supply have some degree of pricing power, whereas a surge in the availability of particular items greatly weakens supplier pricing power and bargaining leverage.

5. Whether certain suppliers provide a differentiated input that enhances the performance or quality of the industry’s product. The more valuable that a particular input is in terms of enhancing the performance or quality of the products of industry members or of improving the efficiency of their production processes, the more bargaining leverage its suppliers are likely to possess.

6. Whether certain suppliers provide equipment or services that deliver valuable cost-saving efficiencies to industry members in operating their production processes. Suppliers who provide cost-saving equipment or other valuable or necessary production-related services are likely to possess bargaining leverage. Industry members that do not source from such suppliers may find themselves at a cost
disadvantage and thus under competitive pressure to do so (on terms that are favorable to the suppliers).

- **Whether suppliers provide an item that accounts for a sizable fraction of the costs of the industry’s product.** The bigger the cost of a particular part or component, the more opportunity for the pattern of competition in the marketplace to be affected by the actions of suppliers to raise or lower their prices.

- **Whether industry members are major customers of suppliers.** As a rule, suppliers have less bargaining leverage when their sales to members of this one industry constitute a big percentage of their total sales. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers. Suppliers then have a big incentive to protect and enhance their customers’ competitiveness via reasonable prices, exceptional quality, and ongoing advances in the technology of the items supplied.

- **Whether it makes good economic sense for industry members to integrate backward and self-manufacture items they have been buying from suppliers.** The make-or-buy issue generally boils down to how purchased components compare to self-manufactured components in quality and price. For instance, boat manufacturers find it cheaper to source marine engines from outside manufacturers who specialize in engine manufacturing rather than make their own engines because the quantity of engines they need is too small to justify the investment in manufacturing facilities, master the production process, and capture scale economies. Specialists in marine engine manufacturing, by supplying engines to the entire boating industry, can obtain a big enough sales volume to fully realize scale economies, become proficient in all the manufacturing techniques, and keep costs low. As a rule, suppliers are safe from the threat of self-manufacture by their customers until the volume of parts a customer needs becomes large enough for the customer to justify backward integration into self-manufacture.

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

**How Collaborative Partnerships Between Industry Members and Their Suppliers Can Create Competitive Pressures** In more and more industries, industry members are forging strategic partnerships with select suppliers in efforts to (1) reduce inventory and logistics costs (e.g., through just-in-time deliveries); (2) speed the availability of next-generation components; (3) enhance the quality of the parts and components being supplied and reduce defect rates; and (4) squeeze out important cost savings for both themselves and their suppliers. Numerous Internet technology applications are now available that permit real-time data sharing, eliminate paperwork, and produce cost savings all along the supply chain. The many benefits of effective seller–supplier collaboration can translate into competitive advantage for industry members who do the best job of managing supply chain relationships.

Dell Inc. has used strategic partnering with key suppliers as a major element in its strategy to be the world’s lowest-cost supplier of branded PCs, servers, and workstations. Because Dell has managed its supply chain relationships in ways that contribute to a low-cost, high-quality competitive edge in components supply, it has put enormous pressure on its PC rivals to try to imitate its supply chain management practices. Effective partnerships with suppliers on the part of one or more industry members can thus become a major source of competitive pressure for rival firms.

The more opportunities that exist for win–win efforts between a company and its suppliers, the less their relationship is characterized by who has the upper hand in
bargaining with the other. Collaborative partnerships between a company and a supplier tend to last so long as the relationship is producing valuable benefits for both parties. Only if a supply partner is falling behind alternative suppliers is a company likely to switch suppliers and incur the costs and trouble of building close working ties with a different supplier.

**Competitive Pressures Stemming from Buyer Bargaining Power and Seller–Buyer Collaboration**

Whether seller–buyer relationships represent a weak or strong competitive force depends on (1) whether some or many buyers have sufficient bargaining leverage to obtain price concessions and other favorable terms and conditions of sale, and
(2) whether strategic partnerships between certain industry members and their customers produce competitive pressures that adversely affect other industry members.

**How Buyer Bargaining Power Creates Competitive Pressures**  As with suppliers, the leverage that certain types of buyers have in negotiating favorable terms 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 haggling is customary, such as the purchase of new and used motor vehicles, homes, and big-ticket items like 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 like Wal-Mart, Best Buy, Staples, and Home Depot typically have considerable negotiating leverage in purchasing products from manufacturers since retailers usually stock just two or three competing brands of a product. In addition, the strong bargaining power of major supermarket chains like Kroger and Safeway 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. “Prestige” buyers have a degree of clout in negotiating with sellers because a seller’s reputation is enhanced by having prestige buyers on its customer list.

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:11

- *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 like washers and dryers are nearly indistinguishable products 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 of the part or component being supplied, the less easy it is for suppliers to find alternative sales opportunities when a customer is lost to a competitor. The prospect of losing a customer that is not easily replaced often makes a seller more willing to grant concessions of one kind or another. In the digital camera industry, for example, the sellers of lenses and other components have little bargaining power because there are a relatively small number of digital camera makers that need their components.

- *If demand for the item being supplied is weak*—Weak or declining demand for suppliers’ products creates a buyer’s market; conversely, strong or rapidly growing demand for suppliers’ products creates a seller’s market and shifts bargaining power to suppliers.
• If buyers of the item being supplied are well informed about the purchase they are considering—The more information buyers have about market conditions surrounding the item being supplied and about the products, prices, and costs of alternative suppliers, the better their bargaining position. The mushrooming availability of product information on the Internet is giving added bargaining power to individuals. Buyers can easily use the Internet to compare prices and features of vacation packages, shop for the best interest rates on mortgages and loans, and find the best prices on big-ticket items such as high-definition TVs. Bargain-hunting individuals can shop around for the best deal on the Internet and use that information to negotiate a better deal from local retailers; this method is becoming commonplace in buying new and used motor vehicles. Further, the Internet has created opportunities for manufacturers, wholesalers, retailers, and sometimes individuals to join online buying groups to pool their purchasing power and approach vendors for better terms than could be gotten individually. A multinational manufacturer’s geographically scattered purchasing groups can use Internet technology to pool their orders with parts and components suppliers and bargain for volume discounts. Purchasing agents at some companies are banding together at third-party websites to pool corporate purchases to get better deals or special treatment.

• If buyers pose a credible threat of integrating backward into the business of their suppliers—Companies like 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. Retailers gain bargaining power by stocking and promoting their own private-label brands alongside manufacturers’ name brands.

• If buyers have discretion in whether and when they purchase the product—Consumers who are unhappy with the present deals offered on discretionary items such as furniture, large appliances, and home electronics may choose to delay purchases until prices and financing terms improve. If college students believe that the prices of new textbooks are too high, they can purchase used copies. Business customers who are not happy with the prices or features of such discretionary items as new manufacturing equipment or computer software upgrades can opt to delay purchase until either terms improve or next-generation products become available.

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

A final point to keep in mind is that not all buyers of an industry’s product have equal degrees of bargaining power, 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 like Macy’s, T. J. Maxx, or Target; but those same manufacturers can command much better prices from small owner-managed apparel boutiques.

How Collaborative Partnerships Between Certain Industry Members and Their Key Customers Can Create Competitive Pressures   Partnerships between sellers and buyers are an increasingly important element of the competitive picture in business-to-business relationships (as opposed to business-to-consumer relationships). Many sellers that provide items to business customers have found it in their mutual interest to collaborate closely with buyers on such matters as just-in-time deliveries, order processing, electronic invoice payments, and data sharing. Wal-Mart,
for example, has entered into partnerships with manufacturers to keep merchandise in stock and to lower its inventory costs. Wal-Mart allows vendors like Procter & Gamble, Sara Lee, or Unilever to monitor store bar-code scanner data to determine when Wal-Mart’s distribution centers need shipments and how big those shipments must be. In some instances, sellers ship inventory directly to each Wal-Mart store as merchandise is sold and shelves become depleted. Wal-Mart’s transition from using bar codes to radio frequency identification (RFID) was welcomed by those of its suppliers who saw an opportunity to boost the sales of their products in Wal-Mart stores. RFID receivers in each Wal-Mart store or distribution center allowed suppliers to track RFID-tagged inventory by number and location. Procter & Gamble and other Wal-Mart suppliers could then connect to Wal-Mart’s computer networks to watch the real-time inventory flow of the items they supplied to Wal-Mart and make just-in-time shipments to prevent inventory stockouts.
Is the Collective Strength of the Five Competitive Forces Conducive to Good Profitability?

Scrutinizing each of the five competitive forces one by one provides a powerful diagnosis of the state of competition in a given market. Once the strategist has gained an understanding of the specific competitive pressures comprising each force and determined whether these pressures constitute a strong, moderate, or weak competitive force, the next step is to evaluate the collective strength of the five forces and determine whether the state of competition is conducive to earning attractively high profits. Is the collective impact of the five competitive forces stronger than “normal”? Are some of the competitive forces sufficiently strong to undermine industry profitability? Can companies in this industry reasonably expect to earn decent profits in light of the prevailing competitive forces?

Is the Industry Competitively Attractive or Unattractive? 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. Intense competitive pressures from just two or three of the five forces may suffice to destroy the conditions for good profitability. Unattractive competitive conditions that include strong substitutes, fierce competitive rivalry, and low buyer switching costs have created a dismal outlook for the movie rental business. In 2007, Blockbuster recorded a net loss of $85 million on revenues of $5.5 billion, while the industry runner-up, Movie Gallery, filed bankruptcy in October 2007 after recording losses for three consecutive years. Movie Gallery lost an additional $70 million by the end of 2007, and its shares were delisted by the NASDAQ in 2008.

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

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

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

1. Pursuing avenues that shield the firm from as many of the different competitive pressures as possible.
2. Initiating actions calculated to shift competition in the company’s favor, put added competitive pressure on rivals, and perhaps even define the business model for the industry.

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

**QUESTION 3: WHAT FORCES ARE DRIVING INDUSTRY CHANGE AND WHAT IMPACTS WILL THEY HAVE?**

While it is critical to understand the nature and intensity of competitive forces in an industry, it is just as important to understand that general industry conditions and an industry’s overall outlook are fluid and subject to change. All industries are affected by new developments and ongoing trends that gradually or speedily produce new industry conditions important enough to require a strategic response from participating firms. The popular hypothesis that industries go through a life cycle of takeoff, rapid growth, early maturity and slowing growth, market saturation, and eventual stagnation or decline helps explain industry change—but there are more causes of industry change than an industry’s normal progression through the life cycle. Just what are the other drivers of industry change? Might they be even stronger drivers of change than progression through the life cycle? And don’t strategy makers need to be alert to all the drivers of industry change, as well as to their likely impacts on industry and competitive conditions, in order to craft company strategies that will fit future industry circumstances?

**The Concept of Driving Forces**

The important thing to understand about industry change is that it occurs because agents of change are working to entice or pressure 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 macroenvironment (see Figure 3.2), but most originate in the company’s more immediate industry and competitive environment.

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

Identifying an Industry’s Driving Forces

Many developments can affect an industry powerfully enough to qualify as driving forces. Some drivers of change are unique, but most fall into one of the following categories (these 14 driving forces are summarized in Table 3.2): 14

- **Changes in an industry’s long-term growth rate**—Shifts in industry growth up or down are a driving force for industry change, affecting 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; ambitious companies with trailing market shares may see the upturn in demand as a golden opportunity to launch offensive strategies to broaden their customer base and move up several notches in the industry standings. A slowdown in the rate at which buyer demand is growing nearly always intensifies rivalry because growth-oriented companies may try to launch aggressive initiatives to take sales and market share away from rivals. If industry sales suddenly turn flat or begin to shrink after years of rising at double-digit levels, competition is certain to intensify. Stagnating sales usually prompt both competitively weak and growth-oriented companies to sell their business operations to those industry members who elect to stick it out; as demand for the industry’s product continues to shrink, the remaining industry members may be forced to close inefficient plants and retrench to a smaller production base. Thus, either a higher or lower rate of industry growth acts to produce new industry conditions, transform the competitive landscape, and trigger strategy changes on the part of some industry members.

- **Increasing globalization**—Competition begins to shift from primarily a regional or national focus to an international or global focus when industry members begin

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seeking out customers in foreign markets or when production activities begin to migrate to countries where costs are lowest. Globalization of competition really starts to take hold when one or more ambitious companies precipitate a race for worldwide market leadership. Globalization can also be precipitated by the blossoming of consumer demand in more and more countries and by the actions of government officials to reduce trade barriers or open up once-closed markets to foreign competitors, as is occurring in many parts of Europe, Latin America, and Asia. Significant differences in labor costs among countries give manufacturers a strong incentive to locate plants for labor-intensive products in low-wage countries and use these plants to supply market demand across the world. Wages in China, India, Vietnam, Mexico, and Brazil, for example, are about one-fourth those in the United States, Germany, and Japan. The forces of globalization are sometimes such a strong driver that companies find it highly advantageous, if not necessary, to spread their operating reach into more and more country markets. Globalization is very much a driver of industry change in such industries as credit cards, cell phones, digital cameras, golf and ski equipment, motor vehicles, steel, petroleum, personal computers, video games, public accounting, and textbook publishing.

- **Emerging new Internet capabilities and applications**—Since the late 1990s, the Internet has woven its way not only into everyday business operations but also into the social fabric of life all across the world. Growing acceptance of Internet shopping and file sharing, the emergence of high-speed connections and Voice over Internet Protocol (VoIP) technology, and an ever-growing series of Internet applications have been major drivers of change in industry after industry. Mounting consumer preferences for buying or sharing music files have profoundly reshaped the music industry and affected traditional brick-and-mortar music retailers. Widespread use of e-mail has forever eroded the revenues of fax services and governmental postal services worldwide. Online course offerings at universities are beginning to revolutionize higher education. Companies are increasingly using online technology to (1) collaborate closely with suppliers and streamline their supply chains and (2) revamp internal operations and squeeze out cost savings. The ability of companies to reach consumers via the Internet increases the number of rivals a company faces and often escalates rivalry by pitting pure online sellers against combination brick-and-click sellers against pure brick-and-mortar sellers. The Internet of the future will feature faster speeds, dazzling applications, and over a billion connected gadgets performing an array of functions, thus driving further industry and competitive changes. But Internet-related impacts vary from industry to industry. The challenges here are to assess precisely how emerging Internet developments are altering a particular industry’s landscape and to factor these impacts into the strategy-making equation.

- **Changes in who buys the product and how 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. Apple’s iPod and other brands of MP3 players have transformed how music is bought and played; album sales in the United States, for example, declined from 785.1 million units in 2000 to 500.5 million units in 2007, whereas there were an estimated 840 million downloads of single digital recordings in 2007. The explosion of features and functions being incorporated into cell phones and their enormous popularity with cell phone users is causing all kinds of waves in telecommunications, video games, and digital photography. Longer life
expectancies and growing percentages of relatively well-to-do retirees are driving big changes in buyer demographics in such industries as health care, prescription drugs, recreational living, and vacation travel.

- **Product innovation**—Industry conditions and the competitive landscape are always affected by rivals racing to be first to introduce one new product or product enhancement after another. An ongoing stream of product innovations tends to alter the pattern of competition in an industry by attracting more first-time buyers, rejuvenating industry growth, and/or creating wider or narrower product differentiation. Successful product introductions strengthen the market positions of the innovating companies, usually at the expense of companies that stick with their old products or that are slow to follow with their own versions of the new product. Product innovation has been a key driving force in such industries as cell phones, big-screen televisions, digital cameras, golf clubs, video games, toys, 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 up whole new industry frontiers. For instance, Voice over Internet Protocol (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). LCD and plasma screen technology and high-definition technology are transforming the television industry. Satellite radio technology has made it possible for satellite radio companies with their largely commercial-free programming to draw millions of listeners away from traditional radio stations whose revenue streams from commercials are dependent on audience size. Technological developments can also produce competitively significant changes in capital requirements, minimum efficient plant sizes, distribution channels and logistics, and experience/learning curve effects. In the steel industry, ongoing advances in electric arc minimill technology (which involve recycling scrap steel to make new products) have allowed steelmakers with state-of-the-art minimills to gradually expand into the production of more and more steel products and steadily take sales and market share from higher-cost integrated producers (which make steel from scratch using iron ore, coke, and traditional blast furnace technology). Nucor Corporation, the leader of the minimill technology revolution in the United States, began operations in 1970 and has ridden the wave of technological advances in minimill technology to become the biggest U.S. steel producer, with 2007 revenues of nearly $16.6 billion. In a space of 30 years, advances in minimill technology have changed the face of the steel industry worldwide.

- **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 acquiring other companies or by launching its own start-up venture, it usually applies its skills and resources in some innovative fashion that pushes competition in new directions. Entry by a major firm thus often
produces a new ball game, not only with new key players but also with new rules for competing. Similarly, the exit of a major firm changes the competitive structure by reducing the number of market leaders (perhaps increasing the dominance of the leaders who remain) and causing a rush to capture the exiting firm’s customers.

- **Diffusion of technical know-how across more companies and more countries**—As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, the competitive advantage held by firms originally possessing this know-how erodes. Knowledge diffusion can occur through scientific journals, trade publications, on-site plant tours, word of mouth among suppliers and customers, employee migration, and Internet sources. In recent years, rapid technology transfer across national boundaries has been a prime factor in causing industries to become more globally competitive.

- **Changes in cost and efficiency**—Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. Advances in fluorescent lightbulb technology and light-emitting diode (LED) technology have enabled manufacturers to produce energy-efficient fluorescent-based spiral lightbulbs and LED lighting products that last several times longer than traditional incandescent bulbs. While the prices of compact fluorescent and LED bulbs are several times greater than incandescent bulbs, they are proving to be far cheaper to use because of their longer lives (as much as eight years between replacements) and the considerable energy savings (as much as $50 over the life of the bulb). As a consequence, sales of incandescent bulbs were on the decline while sales of compact fluorescent and LED bulbs were growing rapidly. When sharply rising prices for crude oil in 2007–2008 caused big jumps in gasoline prices, automakers scrambled to boost the fuel efficiency of their car and truck models—sales of fuel-efficient vehicles like Toyota’s popular hybrid Prius rose while sales of gas-guzzling SUVs fell off dramatically. Declining costs to produce PCs have enabled price cuts and spurred PC sales (especially lower-priced models) by making them more affordable to low-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 buyer tastes and preferences start to diverge, sellers can win a loyal following with product offerings that stand apart from those of rival sellers. In recent years, beer drinkers have grown less loyal to a single brand and have begun to drink a variety of domestic and foreign beers; as a consequence, beer manufacturers have introduced a host of new brands. Buyer preferences for motor vehicles are becoming increasingly diverse, with few models generating sales of more than 250,000 units annually. When a shift from standardized to differentiated products occurs, the driver of change is the contest among rivals to cleverly outdifferentiate one another.

  However, buyers sometimes decide that a standardized, budget-priced product suits their requirements as well as or better than a premium-priced product with lots of snappy features and personalized services. Pronounced shifts toward greater product standardization usually spawn lively price competition and force rival sellers to drive down their costs to maintain profitability. The lesson here is that competition is driven partly by whether the market forces in motion are acting to increase or decrease product differentiation.

- **Reductions in uncertainty and business risk**—Emerging industries are typically characterized by uncertainty over such issues as potential market size, how much
time and money will be needed to surmount technological problems, and what distribution channels and buyer segments to emphasize. Emerging industries tend to attract only risk-taking entrepreneurial companies. Over time, however, if the business model of industry pioneers proves profitable and market demand for the product appears durable, more conservative firms are usually enticed to enter the market. Often, these later entrants are large, financially strong firms looking to invest in attractive growth industries.

Lower business risks and less industry uncertainty also affect competition in international markets. In the early stages of a company’s entry into foreign markets, conservatism prevails—firms limit their downside exposure by using less risky strategies like exporting, licensing, joint marketing agreements, or joint ventures with local companies to accomplish entry. Then, as experience accumulates and perceived risk levels decline, companies move more boldly and more independently, making acquisitions, constructing their own plants, putting in their own sales and marketing capabilities to build strong competitive positions in each country market, and beginning to link the strategies in each country to create a more globalized strategy.

- Regulatory influences and government policy changes—Governments can drive competitive changes by opening their domestic markets to foreign participation or closing them to protect domestic companies. (Note that this driving force is spawned by forces in a company’s macroenvironment.) Government incentives to attract companies to locate plants in their communities can impact competitive conditions. Several southern U.S. states created lucrative incentive packages that induced a number of foreign automakers to build new multibillion-dollar plants employing thousands of workers in their states; these plants, which mostly have nonunion workforces, now provide formidable competition for the unionized plants operated by Ford, General Motors, and Chrysler. In contrast, the National Do Not Call Registry, established in 2003, made it difficult for telemarketers to generate new customers. For example, Scholastic Inc., the world’s largest publisher and distributor of children’s books (including the Harry Potter and Baby-Sitters Club series), had for years relied on telemarketing to sign up new book club members; when its telemarketing campaigns were hampered by the restrictions imposed by the federal Do Not Call legislation, Scholastic turned to Internet-based marketing approaches to generate new customers. But when the Internet campaigns failed to keep Scholastic’s book club subscriber base from eroding and resulted in direct-to-home operating losses of nearly $3 million in 2005, $13 million in 2006, and more than $29 million in 2007, Scholastic management concluded in 2008 that the marketplace changes brought about by the Do Not Call legislation had irreparably harmed the book club industry and made it wise to divest its book club business.

- Changing societal concerns, attitudes, and lifestyles—Emerging social issues and changing attitudes and lifestyles can be powerful instigators of industry change. (As with the preceding driving force, this driving force springs from factors at work in a company’s macroenvironment.) Growing antismoking sentiment has emerged as a major driver of change in the tobacco industry. Concerns about high gasoline prices are causing lifestyle changes in both vehicle purchases and driving habits. Consumer concerns about salt, sugar, chemical additives, saturated fat, cholesterol, carbohydrates, and nutritional value have forced food producers to revamp food-processing techniques, redirect R&D efforts, and compete in developing nutritious, good-tasting products. Safety concerns have driven product
An important part of driving forces analysis is to determine whether the collective impact of the driving forces will be to increase or decrease market demand, make competition more or less intense, and lead to higher or lower industry profitability.

Driving forces analysis, when done properly, pushes company managers to think about what’s around the corner and what the company needs to be doing to get ready for it.

Assessing the Impact of the Driving Forces

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

1. Are the driving forces collectively acting to cause demand for the industry’s product to increase or decrease?
2. Are the driving forces acting to make competition more or less intense?
3. Will the combined impacts of the driving forces lead to higher or lower industry profitability?

Getting a handle on the collective impact of the driving forces usually requires looking at the likely effects of each force separately, since the driving forces may not all be pushing change in the same direction. For example, two driving forces may be 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. The analyst’s objective here is to get a good grip on what external factors are shaping industry change and what difference these factors will make.

Making Strategy Adjustments to Take the Impact of the Driving Forces into Account

The third step of driving-forces analysis—where the real payoff for strategy-making comes—is for managers to draw some conclusions about what strategy adjustments will be needed to deal with the impacts of the driving
The real payoff of driving forces analysis is to help managers understand what strategy changes are needed to prepare for the impacts of the driving forces.

QUESTION 4: WHAT MARKET POSITIONS DO RIVALS OCCUPY—WHO IS STRONGLY POSITIONED AND WHO IS NOT?

Since competing companies commonly sell in different price/quality ranges, emphasize different distribution channels, incorporate product features that appeal to different types of buyers, have different geographic coverage, and so on, it stands to reason that some companies enjoy stronger or more attractive market positions than other companies. Understanding which companies are strongly positioned and which are weakly positioned is an integral part of analyzing an industry’s competitive structure. The best technique for revealing the market positions of industry competitors is strategic group mapping. This analytical tool is useful for comparing the market positions of each firm separately or for grouping them into like positions when an industry has so many competitors that it is not practical to examine each one in depth.

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

A strategic group consists of those industry members with similar competitive approaches and positions in the 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.

An industry contains only one strategic group when all sellers pursue essentially identical strategies and have comparable market positions. At the other extreme, an industry may contain as many strategic groups as there are competitors when each rival pursues a distinctively different competitive approach and occupies a substantially different market position.
The procedure for constructing a strategic group map is straightforward:

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

This produces a two-dimensional diagram like the one for the world automobile industry in Illustration Capsule 3.1.

Several guidelines need to be observed in mapping the positions of strategic groups in the industry’s overall strategy space. 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 broad versus narrow product lines reveals just as much about who is positioned where as looking at single versus multiple distribution channels; that is, one of the variables is redundant. Second, the variables chosen as axes for the map should expose big differences in how rivals position themselves to compete in the marketplace. This, of course, means analysts must identify the characteristics that differentiate rival firms and use these differences as variables for the axes and as the basis for deciding which firm belongs in which strategic group. 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, several maps can be drawn to give different exposures to the competitive positioning relationships present in the industry’s structure. 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.

What Can Be Learned from Strategic Group Maps?

Strategic group maps are revealing in several respects. The most important has to do with which rivals are similarly positioned and are thus close rivals and which are distant rivals. Generally speaking, 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. Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, BMW’s car lineup, customer base, and pricing points are much too different from those of Mazda, Suzuki, and Ford to justify calling them close competitors of
Not all positions on a strategic group map are equally attractive.

BMW. For the same reason, Timex is not a meaningful competitive rival of Rolex, and Holiday Inn Express is not a close competitor of such luxury hotel chains as Ritz-Carlton and Four Seasons.

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. Prevailing competitive pressures and industry driving forces favor some strategic groups and hurt others. Discerning which strategic groups are advantaged and disadvantaged requires scrutinizing the map in light of what has also been learned
from the prior analysis of competitive forces and driving forces. Quite often the strength of competition varies from group to group—there's little reason to believe that all firms in an industry feel the same types or degrees of competitive pressure, since their strategies and market positions may well differ in important respects. For instance, the battle among Ford, Nissan, Hyundai, Toyota, and Honda for customers looking for low-cost, fuel-efficient vehicles is of a different character than the competition among Mercedes, BMW, and Porsche whose models appeal to upper-income buyers more interested in vehicle styling, performance, and brand image cachet. Likewise, the competitive battle between Wal-Mart and Target is more fierce than the rivalry among the flagship stores of couture brands such as Gucci, Chanel, Fendi, Louis Vuitton, Prada, and Versace. Furthermore, industry driving forces 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.

Firms in strategic groups that are being adversely impacted by intense competitive pressures or driving forces may try to shift to a more favorably situated group. But shifting to a different position on the map can prove difficult when entry barriers for the target strategic group are high. Moreover, attempts to enter a new strategic group nearly always increase competitive pressures in the target strategic group. If certain firms are known to be trying to change their competitive positions on the map, then attaching arrows to the circles showing the targeted direction helps clarify the picture of competitive maneuvering among rivals.

2. The profit potential of different strategic groups varies due to the strengths and weaknesses in each group’s market position. The profit prospects of firms in different strategic groups can vary from good to ho-hum to poor because of differing growth rates for the principal buyer segments served by each group, 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.

Thus, part of strategic group map analysis always entails drawing conclusions about where on the map is the “best” place to be and why. Which companies/strategic groups are destined to prosper because of their positions? Which companies/strategic groups seem destined to struggle because of their positions? 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?

Unless a company pays attention to what competitors are doing and knows their strengths and weaknesses, it ends up flying blind into competitive battle. As in sports, scouting the opposition is essential. Competitive intelligence about rivals’ strategies,
their latest actions and announcements, their resource strengths and weaknesses, the efforts being made to improve their situation, and the thinking and leadership styles of their executives is valuable for predicting or anticipating the strategic moves competitors are likely to make next. Good information allows a company to prepare defensive countermoves, to craft its own strategic moves with some confidence about what market maneuvers to expect from rivals, and to exploit any openings that arise from competitors’ missteps or strategy flaws.

**Identifying Competitors’ Strategies and Resource Strengths and Weaknesses**

Keeping close tabs on a competitor’s strategy entails monitoring what the rival is doing in the marketplace and what its management is saying in company press releases, Web postings (especially the presentations management has recently made to securities analysts), and such public documents as annual reports and 10-K filings. (Figure 1.1 in Chapter 1 indicates what to look for in identifying a company’s strategy.) Company personnel may be able to pick up useful information from a rival’s exhibits at trade shows and from conversations with a rival’s customers, suppliers, and former employees. 21 Many companies have a competitive intelligence unit that sifts through the available information to construct up-to-date strategic profiles of rivals—their current strategies, resource strengths and competitive capabilities, and competitive shortcomings. Such profiles are typically updated regularly and made available to managers and other key personnel.

Those who gather competitive intelligence on rivals, however, 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. 22 When MKC officials learned of the action and sued, Avon claimed it did nothing illegal, since a 1988 Supreme Court case had ruled 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.

In sizing up competitors, it makes sense for company strategists to make three assessments:

1. Which competitor has the best strategy? Which competitors appear to have flawed or weak strategies?
2. Which competitors are poised to gain market share, and which ones seem destined to lose ground?
3. Which competitors are likely to rank among the industry leaders five years from now? Do one or more up-and-coming competitors have powerful strategies and sufficient resource capabilities to overtake the current industry leader?
Managers who fail to study competitors closely risk being caught napping when rivals make fresh and perhaps bold strategic moves.

The industry’s current major players are generally easy to identify, but today’s market leaders don’t automatically become tomorrow’s. Some of the industry’s largest firms may be plagued with weaknesses that are causing them to lose ground, while the superior strategies and capabilities of up-and-coming companies may likely soon place them in the position of industry leader. In evaluating which competitors are favorably or unfavorably positioned to gain market ground, company strategists need to focus on why there is potential for some rivals to do better or worse than other rivals. Usually, a competitor’s prospects are a function of whether it is in a strategic group that is being favored or hurt by competitive pressures and driving forces, whether its strategy has resulted in competitive advantage or disadvantage, and whether its resources and capabilities are well suited for competing on the road ahead.

Predicting Rivals’ Next Moves

Predicting the next strategic moves of competitors is the hardest yet most useful part of competitor analysis. Good clues about what actions a specific company is likely to undertake can often be gleaned from how well it is faring in the marketplace, the problems or weaknesses it needs to address, and how much pressure it is under to improve its financial performance. Content rivals are likely to continue their present strategy with only minor fine-tuning. Ailing rivals can be performing so poorly that fresh strategic moves are virtually certain. Ambitious rivals looking to move up in the industry ranks are strong candidates for launching new strategic offensives to pursue emerging market opportunities and exploit the vulnerabilities of weaker rivals.

Since the moves a competitor is likely to make are generally predicated on the views their executives have about the industry’s future and their beliefs about their firm’s situation, it makes sense to closely scrutinize not only company executives’ past actions and leadership styles but also their public pronouncements about where the industry is headed, what it will take to be successful, and what their firm’s situation is. Information from the grapevine about what rivals are doing can also be analyzed. Other considerations in trying to predict what strategic moves rivals are likely to make next include the following:

- Which rivals badly need to increase their unit sales and market share? What strategic options are they most likely to pursue: lowering prices, adding new models and styles, expanding their dealer networks, entering additional geographic markets, boosting advertising to build better brand-name awareness, acquiring a weaker competitor, or placing more emphasis on direct sales via their Web site?
- Which rivals have a strong incentive, along with the resources, to make major strategic changes, perhaps moving to a different position on the strategic group map? Which rivals are probably locked in to pursuing the same basic strategy with only minor adjustments?
- Which rivals are good candidates to be acquired? Which rivals may be looking to make an acquisition and are financially able to do so?
- Which rivals are likely to enter new geographic markets?
- Which rivals are strong candidates to expand their product offerings and enter new product segments where they do not currently have a presence?
To succeed in predicting a competitor’s next moves, company strategists need to have a good feel for each rival’s situation, how its managers think, and what the rival’s best strategic options are. Doing the necessary detective work can be tedious and time-consuming, but scouting competitors well enough to anticipate their next moves allows managers to prepare effective countermoves (perhaps even beat a rival to the punch) and to take rivals’ probable actions into account in crafting their own best course of action.

**QUESTION 6: WHAT ARE THE KEY FACTORS FOR FUTURE COMPETITIVE SUCCESS?**

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

In the bottled water industry, the KSFs are access to distribution (to get the company’s brand stocked and favorably displayed in retail outlets where bottled water is sold), image (the product’s name and the attractiveness of its packaging are deciding factors in choosing a brand for many consumers), low-cost production capabilities, and sufficient sales volume to achieve scale economies in marketing expenditures. 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. Key success factors thus vary from industry to industry, and even from time to time within the same industry, as driving forces and competitive conditions change. Table 3.3 lists the most common types of industry key success factors.

An industry’s key success factors can usually be deduced through identifying the industry’s dominant economic characteristics, assessing what competition is like, considering the impacts of the driving forces, comparing the market positions of industry
## Table 3.3 Common Types of Industry Key Success Factors (KSFs)

<table>
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<th>Category</th>
<th>Examples</th>
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| **Technology-related KSFs**      | • Expertise in a particular technology or in scientific research (important in pharmaceuticals, Internet applications, mobile communications, and most other 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, new product introductions)  
• Clever advertising |
| **Skills and capability–related KSFs** | • A talented workforce (superior talent is important in professional services like 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 Web site and/or skills in using Internet technology applications to streamline internal operations |
| **Other types of KSFs**          | • Overall low costs (not just in manufacturing) so as to be able to meet customers’ expectations of low prices  
• 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 |
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members, and forecasting the likely next moves of key rivals. In addition, the answers to three questions help identify an industry’s KSFs:

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 competitive rivalry and 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. And even among these, two or three usually outrank the others in importance. 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.

The goal of company strategists should be to design a strategy aimed at stacking up well on all of the industry’s current and future KSFs and trying to be distinctively better than rivals on one (or possibly two) of the KSFs. Indeed, companies that stand out or excel on a particular KSF are likely to enjoy a stronger market position—being distinctively better than rivals on one or two key success factors tends to translate into competitive advantage. Hence, using the industry’s KSFs as cornerstones for the company’s strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.23

QUESTION 7: DOES THE OUTLOOK FOR THE INDUSTRY OFFER THE COMPANY A GOOD OPPORTUNITY TO EARN ATTRACTIVE PROFITS?

The final step in evaluating the industry and competitive environment is to use the preceding analysis to decide whether the outlook for the industry presents the company with a sufficiently attractive business opportunity. 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 degrees of risk and uncertainty in the industry’s future.
- Whether the industry as a whole confronts severe problems—regulatory or environmental issues, stagnating buyer demand, industry overcapacity, mounting competition, and so on.
- The company’s competitive position in the industry vis-à-vis rivals. (Being a well-entrenched leader or strongly positioned contender in a lackluster industry may present adequate opportunity for good profitability; however, having to fight a
steep uphill battle against much stronger rivals may hold little promise of eventual market success or good return on shareholder investment, even though the industry environment is attractive.)

- The company’s potential to capitalize on the vulnerabilities of weaker rivals (perhaps converting a relatively unattractive industry situation into a potentially rewarding company opportunity).
- Whether the company has sufficient competitive strength to defend against or counteract the factors that make the industry unattractive.

As a general proposition, if an industry’s overall profit prospects are above average, the industry environment is basically attractive; if industry profit prospects are below average, conditions are unattractive. However, it is a mistake to think of a particular industry as being equally attractive or unattractive to all industry participants and all potential entrants. Attractiveness is relative, not absolute, and conclusions one way or the other 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 and presents good opportunities, a strong case can be made that it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business. When a strong competitor concludes that an industry is relatively unattractive, it may elect to simply protect its present position, invest cautiously if at all, and look for opportunities in other industries. A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business.

**KEY POINTS**

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

1. **What are the industry’s dominant economic features?** Industries 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 experience/learning curve effects. In addition to setting the stage for the analysis to come, identifying an industry’s economic features also promotes understanding of the kinds of strategic moves that industry members are likely to employ.

2. **What kinds of competitive forces are industry members facing, and how strong is each force?** The strength of competition is a composite of five forces: (1) competitive pressures stemming from the competitive maneuvering among industry rivals,
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(2) competitive pressures associated with the market inroads being made by the sellers of substitutes, (3) competitive pressures associated with the threat of new entrants into the market, (4) competitive pressures stemming from supplier bargaining power and supplier–seller collaboration, and (5) competitive pressures stemming from buyer bargaining power and seller–buyer collaboration. The nature and strength of the competitive pressures associated with these five forces have to be examined force by force to identify the specific competitive pressures they each comprise and to decide whether these pressures constitute a strong or weak competitive force. The next step in competition analysis is to evaluate the collective strength of the five forces and determine whether the state of competition is conducive to good profitability. Working through the five-forces model step by step not only aids strategy makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better match company strategy to the specific competitive character of the marketplace. Effectively matching a company’s strategy to the particular competitive pressures and competitive conditions that exist has two aspects: (1) pursuing avenues that shield the firm from as many of the prevailing competitive pressures as possible, and (2) initiating actions calculated to produce sustainable competitive advantage, thereby shifting competition in the company’s favor, putting added competitive pressure on rivals, and perhaps even defining the business model for the industry.

3. What forces are driving changes in the industry, and what impact will these changes have on competitive intensity and industry profitability? Industry and competitive conditions change because forces are in motion that create incentives or pressures for change. The first phase is to identify the forces that are driving change in the industry; the most common driving forces include changes in the long-term industry growth rate, globalization of competition in the industry, emerging Internet capabilities and applications, changes in buyer composition, product innovation, technological change and manufacturing process innovation, marketing innovation, entry or exit of major firms, diffusion of technical knowhow, changes in cost and efficiency, growing buyer preferences for differentiated versus standardized products (or vice versa), reductions in uncertainty and business risk, regulatory influences and government policy changes, and changing societal and lifestyle factors. 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. Are the driving forces causing demand for the industry’s product to increase or decrease? Are the driving forces acting to make competition more or less intense? Will the driving forces lead to higher or lower industry profitability?

4. What market positions do industry rivals occupy—who is strongly positioned and who is not? Strategic group mapping is a valuable tool for understanding the similarities, differences, strengths, and weaknesses inherent in the market positions of rival companies. Rivals in the same or nearby strategic groups are close competitors, whereas companies in distant strategic groups usually pose little or no immediate threat. The lesson of strategic group mapping is that some positions on the map are more favorable than others. The profit potential of different strategic groups varies due to strengths and weaknesses in each group’s market position. Often, industry driving forces and competitive pressures favor some strategic groups and hurt others.
5. *What strategic moves are rivals likely to make next?* This analytical step involves identifying competitors’ strategies, deciding which rivals are likely to be strong contenders and which are likely to be weak, evaluating rivals’ competitive options, and predicting their next moves. 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. Managers who fail to study competitors risk being caught unprepared by the strategic moves of rivals.

6. *What are the key factors for future competitive success?* An industry’s key success factors (KSFs) are the particular strategy elements, product attributes, competitive capabilities, and business outcomes that spell the difference between being a strong competitor and a weak competitor—and sometimes between profit and loss. KSFs by their very nature are so important to competitive success that *all firms* in the industry must pay close attention to them or risk becoming an industry also-ran. Correctly diagnosing an industry’s KSFs raises a company’s chances of crafting a sound strategy. The goal of company strategists should be to design a strategy aimed at stacking up well on all of the industry KSFs and trying to be *distinctively better* than rivals on one (or possibly two) of the KSFs. Indeed, using the industry’s KSFs as *cornerstones* for the company’s strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.

7. *Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?* If an industry’s overall profit prospects are above average, the industry environment is basically attractive; if industry profit prospects are below average, conditions are unattractive. Conclusions regarding industry attractive are a major driver of company strategy. When a company decides an industry is fundamentally attractive, a strong case can be made that it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business. When a strong competitor concludes an industry is relatively unattractive, 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.

A competently conducted industry and competitive analysis generally tells a clear, easily understood story about the company’s external environment. Different analysts can have different judgments about competitive intensity, the impacts of driving forces, how industry conditions will evolve, how good the outlook is for industry profitability, and the degree to which the industry environment offers the company an attractive business opportunity. However, while no method can guarantee a single conclusive diagnosis about the state of industry and competitive conditions and an industry’s future outlook, this doesn’t justify shortcutting hard-nosed strategic analysis and relying instead on opinion and casual observation. Managers become better strategists when they know what questions to pose and what tools to use. This is why this chapter has concentrated on suggesting the right questions to ask, explaining concepts and analytical approaches, and indicating the kinds of things to look for. There’s no
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substitute for doing cutting-edge strategic thinking about a company’s external situation—anything less weakens managers’ ability to craft strategies that are well matched to industry and competitive conditions.

ASSURANCE OF LEARNING EXERCISES

1. Using your favorite Internet search engine, do some research on competitive forces and driving forces that are at work in the snack food industry. Draw a five-forces diagram for the snack food industry and briefly discuss the nature and strength of each of the five competitive forces. Make a list of the driving forces operating in the snack foods industry and draw some conclusions about whether the likely impact of these driving forces on snack foods companies will be favorable or unfavorable.

2. Refer back to the strategic group map in Illustration Capsule 3.1: Who are Toyota’s closest competitors? Between which two strategic groups is competition the strongest? Why do you think no automobile manufacturers 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?

3. Using the information provided in Table 3.2 and your knowledge as a casual dining patron, what are the key success factors for restaurants such as Outback Steakhouse or Carrabba’s Italian Grill? Your list should contain no more than six industry key success factors. In deciding on your list, it’s important to distinguish between factors critical to success in the industry and factors that enhance a company’s overall well-being.

EXERCISES FOR SIMULATION PARTICIPANTS

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? Refer back to Figure 3.4 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 3.4 and the accompanying discussion to help you pinpoint 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 in order 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 KSFs.