

chapter 2

Industry Competition

This chapter marks the beginning of the strategic management process and is the first of three that consider the external environment. At this point we are focusing on factors *external* to the organization, viewing firm performance from an industrial organization (IO) perspective. *Internal* factors (e.g., company resources, strategies) are considered later in the process.

Each business operates among a group of rivals that produce competing products or services known as an **industry**. The concept of an industry is a simple one, but it is often confused in everyday conversations. The term *industry* does not refer to a single company or specific firms in general. For example, in the statement, “A new industry is moving to the community,” the word *industry* should be replaced by *company* or *firm*.

Each industry tends to have its own *rules of engagement* governing such issues as product quality, pricing, and distribution. This is especially true for industries that contain a large number of businesses offering standardized products and services. Most competitors—but not all—follow the rules. For example, service stations in the United States generally offer regular unleaded, midgrade, and premium unleaded gasoline at prices that do not differ substantially from those at nearby stations. They typically offer an array of soft drinks, snacks, and other convenience items as well. These rules, or norms, developed because they tend to serve the market effectively. “Breaking the rules” and charting a different strategic course might be possible, but businesses that deviate too much from the norm often fail. As such, it is important for strategic managers to understand the structure of the industry(s) in which their firms operate before deciding how to compete successfully.

While industry norms suggest business practices common to most firms in an industry, **critical success factors (CSFs)** represent elements of the strategy that are essential for success for most rivals. CSFs can be gleaned by examining current and recent examples of success and failure in an industry; they include factors such as competitive capabilities, product or service attributes, service speed, or even locations. For example, CSFs in the automobile industry include vehicle reliability, safety, and modern styling. A firm that possesses these factors is more likely

than others to succeed. CSFs are only predictors of success and failure, however. They do not guarantee any level of performance.

Industry norms are particularly interesting in the airline industry, where there is a tendency for major competitors to follow similar approaches to pricing and fees. Penalties for ticket changes typically range from \$100 to \$150 and are commonly applied across the industry and are usually paid by business travelers. Individual airlines hesitate to deviate from the norm because they would repel customers if they charged more, and they would sacrifice profits if they charged less. According to the U.S. Department of Transportation, ticket change and cancellation fees net airlines in the United States about \$2 billion per year.¹

While the notion of an airline industry is commonly understood, defining a firm's industry is not always an easy task. In a perfect world, each firm would operate in one clearly defined industry. However, many firms compete in multiple industries, and strategic managers in similar firms often differ in their conceptualizations of the industry environment. In addition, some companies have utilized the Internet to redefine industries or even invent new ones, such as eBay's online auction or Priceline's travel businesses. As a result, the process of industry definition and analysis can be especially challenging when Internet competition is considered.²



A number of outside sources can assist a strategic manager in determining which competitors are in the industry, which are not, and why. Government classification systems, such as the popular Standard Industrial Classification (SIC), as well as distinctions made by trade journals and business analysts can help strategists “draw the industry lines.” Although the U.S. Census Bureau replaced the 4-digit SIC system in 1997 with the 6-digit North American Industry Classification System (NAICS)—an alternative system designed to facilitate comparisons of business activities across North America—SIC codes continue to be referenced. The first two NAICS digits represent 1 of 20 industry sectors (e.g., agriculture, mining, utilities), the third digit represents the industry subsector, the fourth represents the industry group, and the fifth represents the industry; the sixth digit is reserved for nation-specific categories in the United States, Canada, or Mexico. The SIC and NAICS categories are worthwhile considerations, but astute managers assess these and other sources and add their own rigorous and systematic analysis of the competition when defining the industry. Additional information on both classification schemes is readily available on the Internet.

Numerous descriptive factors can be employed when drawing the industry lines. In the case of McDonald's, for example, attributes such as speed of service, types of products, prices of products, and level of service may be useful. Hence, one might define the industry for McDonald's in the United States as consisting of restaurants offering easy-to-consume, moderately priced food products rapidly and in a limited service environment. Broad terms like *fast food* are often used to describe such industries, but doing so does not eliminate the need for a clear, tight definition. Terms like *fast food* can have different meanings to different people.

Some factors are usually not helpful when defining an industry, however, such as those directly associated with strategy and firm size. For example, it is not a good idea to exclude a fast food restaurant in the industry for McDonald's because it is not part of a large chain or because it emphasizes low-priced food. These factors explain how such a restaurant might be *positioned vis-à-vis* McDonald's, a concept discussed in greater detail in later chapters.

Industries also change over time. In the mid-2000s, for example, consumer electronics big-box stores Best Buy and Circuit City began to face increasing price competition from online retailers. When the economy turned sour in 2008, Circuit City's survival was drawn into question. The retailer filed for bankruptcy in 2009 and was dissolved, a departure that redefined the entire industry. Without Circuit City in the picture, Best Buy shifted its competitive efforts to Wal-Mart. After enjoying a period of success, Best Buy began to struggle as online competitors gained more favor with customers.³ Hence, Best Buy's industry has shifted markedly since 2009.

The concept of primary and secondary industries can be a useful tool in defining an industry. A primary industry may be conceptualized as a group of close competitors whereas a secondary industry includes less direct competition. When one analyzes a firm's competition, the primary industry is loosely considered to be *the industry* whereas the secondary industry is presented as a means of adding clarity to the analysis. For example, the primary industry for McDonald's includes such competitors as Burger King and Wendy's whereas its secondary industry might also include restaurants that do not emphasize hamburgers and offer more traditional restaurant seating such as Pizza Hut and Denny's. The distinction between primary and secondary industry may be based on objective criteria such as price, similarity of products, or location, but there is always some degree of subjectivity and informed judgment involved in assigning an industry definition.

Once the industry is defined, it is important to identify the **market share**—a competitor's share of the total industry sales—for the firm and its key rivals. Unless stated otherwise, market share calculations are usually based on total sales revenues of the firms in an industry rather than units produced or sold by the individual firms. This information is often available from public sources, especially when there is a high level of agreement as to how an industry should be defined. When available market share information is based on a different industry definition, however, the data can be misleading. For example, Southwest Airlines would appear to have a *higher* market share and a *stronger* market position if its industry is defined in terms of North American airlines. Southwest would look like a smaller player when its industry is defined in global terms.

When market share is not available or when there are substantial differences in industry definitions, **relative market share**—a firm's share of industry sales when only the firm and its key competitors are considered—can serve as a practical substitute. Consider low-end discount retailer Dollar Tree as an example and assume that the only available market share data considers Dollar Tree to be part of the broadly defined discount department store industry. If a more narrow industry definition is proposed—perhaps one limited to deep discount retailers—new market share calculations will be necessary. In addition, it becomes quite complicated when one attempts to include the multitude of mom-and-pop nonchain discounters in the calculations. In this situation, computing relative market shares that consider Dollar Tree and its major competitors can be useful. Assume for the sake of this example that there are four major competitors identified in this industry—Dollar General, Family Dollar, Dollar Tree, and Fred's—with annual sales of \$13 billion, \$9 billion, \$6 billion, and \$2 billion sequentially. Relative market share would be calculated on the basis of a total market size of \$30 billion (i.e., $13+9+6+2$). In this example, relative market shares for the competitors are 43%, 30%, 20%, and 7% sequentially. From a practical standpoint, calculating relative market share can be appropriate when external data sources are limited.

A firm's market share can also become quite complex as various industry or market restrictions are added. Unfortunately, the precise market share information most useful to a firm may be based on a set of industry factors so complex that computing it becomes an arduous task. In a recent analysis, the Mintel International Group set out to identify the size of the healthy-snack market in the United States, a task complicated by the fact that many products such as cheese, yogurt, and cereal are eaten as snacks in some but not all instances.⁴ To overcome this barrier, analysts computed a total for the healthy-snack market by adding only the proportion of each food category consumed as a healthy snack. In other words, 100% of the total sales of products like popcorn and trail mix—foods consumed as healthy snacks 100% of the time—were included in the total. In contrast, only 40% of cheese consumption, 61% of yogurt consumption, and 21% of cereal consumption were included in the total. While this approach is reasonable and can be quite useful, it can only be calculated when one has access to data that may not be readily available. Hence, analysts must use the best data available to describe the relative market positions of the competitors in a given industry.

Industry Life Cycle Stages

Once the industry is defined, it is helpful to understand its stage of development. Like firms, industries develop and evolve over time. Not only might the group of competitors within a firm's industry change constantly but the nature and structure of the industry can also change as it matures and its markets become better defined.

An industry's developmental stage influences the nature of competition and potential profitability among competitors.⁵ While identifying the current life cycle stage in an industry can be challenging, it is important to understand how the industry shifts over time. When top managers understand these changes, they can position their firms for both current and future success.

In theory, each industry passes through five distinct phases of an **industry life cycle** (see Figure 2.1).

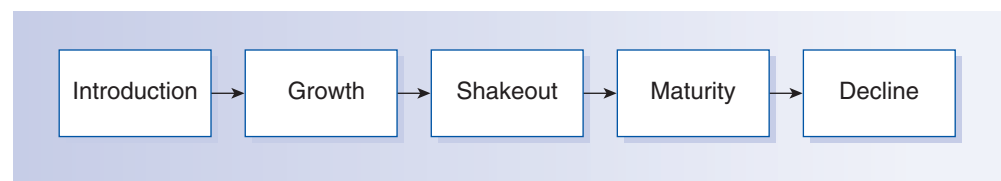


Figure 2.1 The Industry Life Cycle

A young industry that is beginning to form is considered to be in the *introduction* stage. Demand for the industry's outputs is low at this time because product and/or service awareness is still developing. Virtually all purchasers are first-time buyers and tend to be affluent, risk tolerant, and innovative. Technology is a key concern in this stage because businesses often seek ways to improve production and distribution efficiencies as they learn more about their markets. Industries typically progress through the introduction stage very quickly. The existence of new firms with products and services that differ significantly from those currently available in the marketplace is often a sign of a new industry. Although the new firms might not survive buyer scrutiny, the life cycle model assumes that legitimate industries proceed to the next stage of development.

Normally, after key technological issues are addressed and customer demand begins to rise, the industry enters the *growth* stage. Growth continues but tends to slow as the market demand approaches saturation. Fewer first-time buyers remain, and most purchases tend to be upgrades or replacements. Many competitors are profitable, but available funds may be heavily invested into new facilities or technologies. Some of the industry's weaker competitors may go out of business in this stage.

Shakeout occurs when industry growth is no longer rapid enough to support the increasing number of competitors. As a result, a firm's growth is contingent on its resources and competitive positioning instead of a high growth rate within the industry. Marginal competitors are forced out, and a small number of industry leaders may emerge.

Maturity is reached when the market demand for the industry's outputs is becoming saturated. Virtually all purchases are upgrades or replacements, and industry growth may be low, nonexistent, or even negative. Industry standards for quality and service have been established, and customer expectations tend to be more consistent than in previous stages. The U.S. automobile industry is a classic example of a mature industry. Firms in mature industries often seek new uses for their products or services or pursue new markets—often through global expansion. By doing so, they seek to revert to a more prosperous growth stage, as U.S. automakers have done by expanding vigorously into Asia and other parts of the world. In essence, they have redefined their industry in global terms.



The online auction industry is also in (or is rapidly approaching) the maturity stage—at least from the perspective of the U.S. market. The first online auction can be traced back to the 1980s, but significant industry growth did not commence until the mid-1990s when Onsale, Yahoo, eBay, and others entered the market. Shakeout occurred in the late 1990s and early 2000s as buyers and sellers began to coalesce around eBay and rivals exited the industry. Today, eBay is the dominant player across product lines, accompanied by a number of specialty auction sites such as StubHub (event tickets) and Auction.com (real estate). Of course, industry characteristics vary in other countries and additional growth is possible, particularly as more consumers in developing nations gain access to the Internet.

The *decline* stage occurs when demand for an industry’s products and services decreases and often begins when consumers begin to turn to more convenient, safer, or higher quality offerings from firms in substitute industries. The once-stellar typewriter industry declined when people began using personal computers instead. Some firms may divest their business units in this stage whereas others may seek to “reinvent” themselves and pursue a new wave of growth associated with a similar product or service.

Growth is difficult to achieve when an industry is in decline. There are exceptions to the rule, however. Lorillard is the third largest cigarette producer in the United States. Sales at the top two producers—Altria Group and Reynolds American—declined 23% and 25% respectively from 2006 to 2010. Cigarette consumption declined markedly during the period as well, but Lorillard sales actually grew by 4%, increasing its market share from 11% to 14%. The company has bucked the trend in part by focusing on menthol brands like Newport and in part because its customers are younger on average than those of its rivals. Maintaining growth in the 2010s will be a challenge, however, as the industry will likely face increased government regulation and declining consumer demand.⁶

A number of external factors can facilitate movement along the industry life cycle. When oil prices spiked in 2005 and again in early 2012, for example, firms in oil-intensive industries such as airlines and carmakers began to feel the squeeze.⁷ When an industry is mature, firms are often better able to withstand such pressures and survive.

Although the life cycle model is useful for analysis, identifying an industry’s precise position is often difficult, and not all industries follow these exact stages or at predictable intervals.⁸ For example, the U.S. railroad industry did not reach maturity for many decades and extended over 100 years before entering decline whereas the personal computer industry began to show signs of maturity after only 7 years. As the previous examples in the automobile and online auctions demonstrate, the stage of an industry’s development can vary across borders. Moreover, following an industry’s decline, changes in the macroenvironment may revitalize new growth. For example, the bicycle industry fell into decline when the automobile gained popularity but has since been rejuvenated by society’s interest in health and physical fitness.

The notion of **hypercompetition** also creates a challenge. According to this perspective, industries emerge, develop, and evolve so rapidly that attempting to remain in the current stage may be neither possible nor worthwhile.⁹ Because the old rules of industry evolution and competition are no longer valid, executives should be wary of life cycle models. For these reasons, identifying the industry life cycle stage can inform the strategic management process, but it is important not to place too much emphasis on the stage when making strategic decisions (see Case Analysis 2.1).



Case Analysis 2.1**Step 2: Identification of the Industry, the Life Cycle Stage, and the Competitors**

After the organization has been introduced, its industry must be defined in specific terms. This process can be difficult, depending on the firm. For example, most would agree that Kroger is in the "grocery store industry," and its competition comes primarily from other grocery stores. However, not all industry decisions are this simple. For example, should Wal-Mart be classified in the department store industry (competing with upscale mall-oriented stores) or in the discount retail industry (competing with low-end retailers such as Family Dollar)? Does Pizza Hut compete in the fast-food industry or in the broader restaurant industry? To further complicate matters, many corporations are diversified and compete in a number of different industries. For example, Anheuser-Busch operated both breweries and several theme parks before InBev acquired the firm and divested the parks in 2009. In cases in which multiple business units are competing in different industries, one needs to identify multiple industries. Market shares or relative market shares for the firm and its key competitors—based on the best available data—should also be identified.

The industry life cycle stage should also be identified. As discussed in future chapters, changes in firm- and business-level strategies may be necessary as the industry evolves. Understanding the stage is an important precursor to developing appropriate strategies.

The importance of clarifying the industry definition at the outset cannot be overstated. External environmental forces that affect the industry cannot be assessed realistically without a clear definition. In addition, a firm's relative strengths and weaknesses can be classified as such only when compared to other companies in the industry.

Industry Structure

Factors associated with industry structure can play a dominant role in the performance of many companies with the exception of those that are their notable leaders or failures.¹⁰ As such, one needs to understand these factors at the outset before delving into the characteristics of a specific firm. Michael Porter, a leading authority on industry analysis, proposed a systematic means of analyzing the potential profitability of firms in an industry known as Porter's *five forces model*.¹¹ According to Porter, an industry's overall profitability (i.e., the combined profits of all competitors) depends on five basic competitive forces, the relative weights of which vary by industry (see Figure 3.2):

1. The intensity of rivalry among incumbent firms
2. The threat of new competitors entering the industry
3. The threat of substitute products or services
4. The bargaining power of buyers
5. The bargaining power of suppliers

These five factors combine to form the industry structure, and they suggest (but do not guarantee) profitability prospects for firms that operate in the industry. Each of the factors will be discussed in greater detail.

Intensity of Rivalry Among Incumbent Firms

Competition intensifies when a firm identifies the opportunity to improve its position or senses competitive pressure from other businesses in its industry, which can result in price wars,

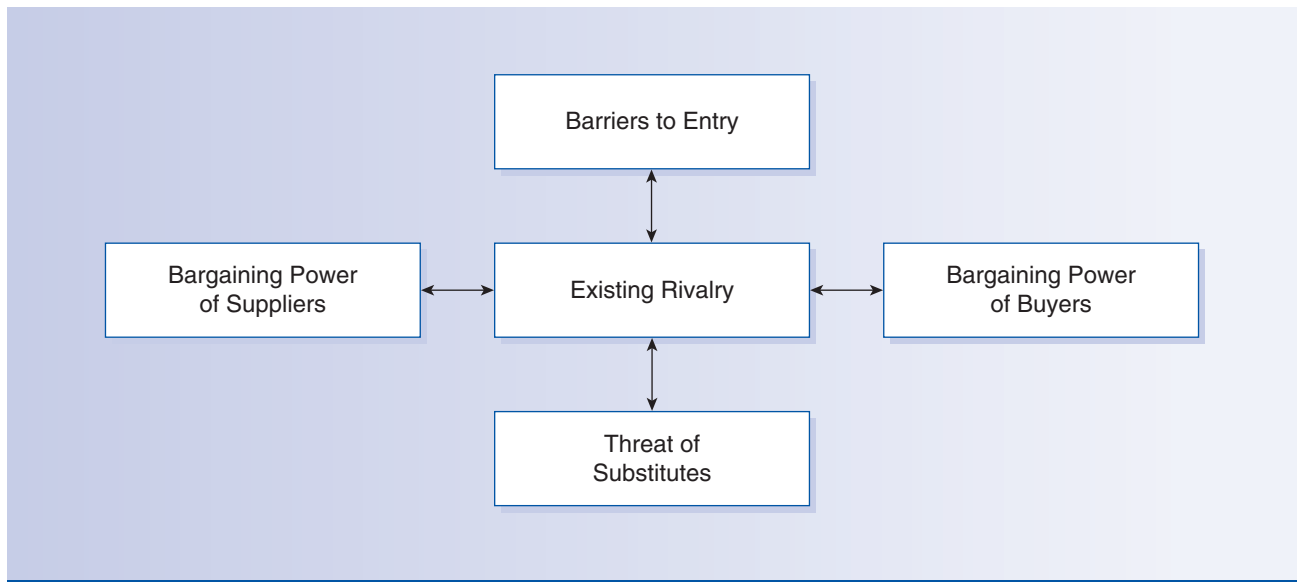


Figure 2.1 Porter's Five Forces Model

advertising battles, new product introductions or modifications, and even increased customer service or warranties.¹² Rivalry can be intense in some industries. For example, a battle is waging in the U.S. real estate industry, where traditional brokers who earn a commission of 5% to 6% are being challenged by discount brokers who charge sellers lower fees. Agents for the buyer and seller typically split commissions, which usually fall in the \$7,000 range for both agents when a home sells for \$250,000. *Discount brokers argue* that the most critical service provided by the seller's agent is listing the home in a multiple listing service (MLS) database, the primary tool used by most buyers and their agents to peruse available properties. Some discount brokers and do-it-yourself firms like FSBO.com provide sellers with an MLS listing for a flat fee in a number of markets—sometimes less than \$1,000. Traditional brokers are angry, however, and argue that discount brokers do not provide the full array of services available from a full service broker. Traditional brokers continue to dominate the industry, however. They often control the local MLS databases (see realtor.com), and many discount brokers claim that they are not provided equal access to list their properties.¹³ Rivalry in this industry—especially between full service and discount brokers—remains quite intense.

Many retail sectors—from consumer electronics to department stores—are highly competitive. In the United States, the intensity of rivalry is most apparent on the day after Thanksgiving, the official beginning of the Christmas shopping season. Retailers typically slash prices and offer huge incentives to attract customers on this day known as “Black Friday.” Many stores open as early as 5:00 am with discounts so deep that some consumers begin forming a line the day before. In 2011, a number of stores including Target, Macy's, Kohl's, and Best Buy even backed their opening times to midnight to get a jump on the competition.¹⁴

A similar situation exists in the airline industry, where fares are not based solely on cost and distance traveled but also on competitive pressures. One study found that passengers flying out of Pittsburgh paid an average of 77% less per mile for a domestic airline ticket when compared to passengers flying out of Cincinnati. The reason for the difference has little if any to do with airport costs but instead with the presence of discount airlines such as Southwest Airlines and AirTran Airways.¹⁵ Hence, rivalry in this industry is intense, and price wars can have a keen effect on firm behavior.

Competitive intensity often evolves over time and depends on a number of interacting factors, as discussed next. Each of these factors should be assessed independently and then integrated into an overall perspective.

Concentration of Competitors

Both the number of companies in the industry and their relative sizes or power levels influence an industry's intensity of rivalry. Industries with few firms tend to be less competitive, but those with many firms that are roughly equivalent in size and power tend to be more competitive, as each one fights for dominance. Competition is also likely to be intense in industries with large numbers of firms because some of those companies may believe that they can make competitive moves without being noticed.¹⁶

A quick means of assessing market concentration is to sum the market shares of the four leading firms in an industry. The larger the four-firm concentration ratio, the more concentrated the industry. A limitation of this measure is that it does not consider the relative sizes of the top four firms—only the sum. An industry with five rivals each holding 20% of the market would be more competitive than an industry whose largest four firms hold 75%, 2%, 2%, and 1% respectively. In this example, however, both industries would have the same four-firm concentration ratio: 80.

The **Herfindahl-Hirschman Index (HHI)** is a commonly accepted, more sophisticated measure of market concentration. The HHI is calculated by summing the squares of the market shares for each firm competing in an industry. Following the previous example, the HHI in the first industry would be $20^2 + 20^2 + 20^2 + 20^2 + 20^2$, or 2,000 whereas the HHI in the second industry would be $75^2 + 2^2 + 2^2 + 1^2$, or 5,634. The higher the HHI, the more concentrated the industry.¹⁷

Regulators often block proposed mergers and acquisitions when industry concentration is high. Historically, the U.S. Department of Justice and the Federal Trade Commission have considered HHI scores above 1,800 to be concentrated and scores below 1,000 to be unconcentrated. These regulators have often approved proposed mergers where the HHI would remain below 1,000 and rejected those where the resulting HHI would be above 1,800. Proposed mergers resulting in an HHI between 1,000 and 1,800 require additional scrutiny. The heavy reliance on the HHI in assessing the competitive effects of a proposed merger is changing, however, as other industry- and firm-specific factors have become greater considerations.

Needless to say, the HHI depends on one's definition of industry, and firms involved in proposed mergers tend to argue for broader definitions than do regulators. The same holds true when regulators seek to dismantle a monopoly, such as occurred in 1982 when the U.S. Department of Justice "broke up" the single telephone company AT&T into seven regional holding companies. When Office Depot and Staples announced plans to merge in 1996, the two firms claimed to control only 6% of the market for office supplies. Regulators, however, limited the industry to "superstores," claiming a much higher figure and charging that a merger would stifle competition. To prove this claim, they noted that prices at Staples stores were higher in towns where there was no Office Depot. The merger was rejected, and both retailers have operated as separate entities ever since.¹⁸

When the satellite radio providers Sirius and XM announced a merger in 2007, critics—including many in the U.S. Department of Justice—claimed that the combined company would hold a monopoly and consumers would be forced to pay higher prices. Company executives questioned the industry definition, as satellite radio is not the only means by which consumers can access a wide array of information, music, and other audio programming. When terrestrial radio and the Internet are also considered, satellite radio represents only a small percentage of the overall market. The Justice Department closed its investigation of the proposed merger in 2008, at which time the two entities were combined to form Sirius XM.

Similar arguments continue to be made in the case of Microsoft's Windows operating system. Critics claim Microsoft controls 80% of the operating system industry whereas Microsoft argues that it is a small player in the broader software industry. Hence, the notion of market concentration is inseparable from one's definition of the industry.

High Fixed or Storage Costs

When firms have unused productive capacity, they often cut prices in an effort to increase production and move toward full capacity. The degree to which prices (and profits) can fall under such conditions is a function of the firms' cost structures. Those with high fixed costs are most likely to cut prices when excess capacity exists because they must operate near capacity to be able to spread their overhead over more units of production.

The U.S. airline industry experiences this problem periodically, as losses generally result from planes that are flying either with lots of empty seats or are not flying at all. This dynamic often results in last-minute fare specials in an effort to fill vacant seats. Consider the difficult times for U.S. airlines immediately following the 9/11 terrorist attacks. Price wars were common and were even initiated by low-cost airlines such as JetBlue and Southwest.¹⁹

Slow Industry Growth

Firms in industries that grow slowly are more likely to be highly competitive than companies in fast-growing industries. In slow-growth industries, one firm's increase in market share must come primarily at the expense of other firms' shares. Competitors often place more attention to the actions of their rivals than to consumer tastes and trends when formulating strategies.

Slow industry growth can be caused by a sluggish economy, as was the case for vehicles during the early 2000s and again in the early 2010s. As a result, manufacturers began to emphasize value by enhancing features and cutting costs. In the early 2000s, Ford, General Motors, Nissan, Toyota, and others began to produce slightly larger trucks with additional features while trimming prices. Producers also began to develop lower-priced luxury cars in a fierce battle for sales.²⁰ In the early 2010s, many producers emphasized value and fuel economy to attract buyers.

Slow industry growth—and even a decline in total revenues—is frequently caused by shifts in consumer demand patterns. For example, per capita consumption of carbonated soft drinks in the United States fell from its peak of 54 gallons in 1997 to around 46 gallons by 2009. During this same period, annual world growth declined as well as rising consumption of fruit juices, energy drinks, bottled water, and other noncarbonated beverages. Coca-Cola and PepsiCo acquired or developed a number of noncarbonated brands during this time in efforts to counter the sluggish growth prospects in soft drinks. Interestingly, these rivals now appear to have modified their industry definitions from a narrow “soft drink” focus to a broader perspective including noncarbonated beverages.²¹

Lack of Differentiation or Low Switching Costs

The more similar the offerings among competitors, the more likely customers are to shift from one to another. As a result, such firms tend to engage in price competition. When **switching costs**—one-time costs that buyers incur when they switch from one company's products or services to another—are low, firms are under considerable pressure to satisfy customers who can easily switch competitors at any time. Likewise, when products or services are less differentiated, purchase decisions are based on price and service considerations, resulting in greater competition.

Switching costs include both financial and nonfinancial costs that must be incurred by customers who switch from one rival to another. For example, the switching costs for PC users who switch to a Mac include *both* financial outlays—the price of a new computer, software, and the like—and the time, energy, and effort required to become accustomed with a new operating system. Hence, where switching costs are high, the original producers tend to retain a strong position and can even thwart newcomers with more attractive offerings and prices.

Interestingly, firms often seek to create switching costs in efforts to encourage customer loyalty. Internet service provider (ISP) America Online (AOL), for example, encourages its users to obtain and use AOL e-mail accounts. Historically, these accounts were eliminated if the AOL customer switched to another ISP. When free e-mail accounts with Yahoo and other providers proliferated in the mid-2000s, AOL loosened this restriction in 2006, suggesting that most consumers no longer see the loss of an e-mail account as a major factor when considering a switch to another ISP. Frequent-flier programs also reward fliers who patronize one or a limited number of airlines.

The cellular telephone industry in the United States benefited from key switching costs for a number of years. Until regulations changed in late 2003, consumers who switched providers were not able to keep their telephone numbers. Hence, many consumers were reluctant to change due to the complications associated with alerting friends and business associates of the new number. Today, however, number portability greatly reduces switching costs, allowing consumers to retain their original telephone number when they switch providers.²² Of course, cellular providers continue to offer free to deeply discounted phones with 1- and 2-year commitments to make switching difficult. Hence, while prospective newcomers prefer low switching costs to facilitate entry into an industry, incumbents tend to raise these costs whenever possible to keep them out.

Capacity Augmented in Large Increments

When production can be easily added in single increments, overcapacity is not a major concern. However, if economies of scale or other factors dictate that production be augmented in large blocks, then capacity additions may lead to temporary overcapacity in the industry, and firms may cut prices to clear inventories. Airlines and hotels, for example, must acquire additional capacity in large increments because it is not feasible to add a few airline seats or hotel rooms as demand warrants. When additional blocks of seats or rooms (i.e., additional planes or hotels) become available, firms are under intense pressure to cover the additional costs by filling them.

Diversity of Competitors

Companies that are diverse in their origins, cultures, and strategies often have different goals and means of competition. Such firms may have a difficult time agreeing on a set of “rules of combat.” As such, industries with global competitors or with entrepreneurial owner-operators tend to be diverse and particularly competitive. Internet businesses often “change the rules” for competition by emphasizing alternative sources of revenue, different channels of distribution, or a new business model. This diversity can increase rivalry sharply.

High Strategic Stakes

Competitive rivalry is likely to be high if firms also have high stakes in achieving success in a particular industry. For many strong, traditional companies, failing in their web-based ventures may not be seen as an option. A web presence is viewed as necessary regardless of profitability. Large global firms seeking a permanent presence in a particular country might be willing to operate at a loss for an extended period of time. In industries with high strategic stakes, new entrants would be forced to compete with existing firms that are not even profitable.

High Exit Barriers

Exit barriers are economic, strategic, or emotional factors that keep companies from leaving an industry even though they are not profitable or may even be losing money. Examples of

exit barriers include fixed assets that have no alternative uses, labor agreements that cannot be renegotiated, strategic partnerships among business units within the same firm, management's unwillingness to leave an industry because of pride, and governmental pressure to continue operations to avoid adverse economic effects in a geographic region.²³ When substantial exit barriers exist, firms choose to compete at a loss as a lesser of two evils—a practice that can drive down the profitability of competitors as well.

Threat of Entry

An industry's productive capacity expands when new competitors enter. Unless the market is growing rapidly, new entrants intensify the fight for market share, lowering prices, and, ultimately, industry profitability. When large, established firms control an industry, new entrants are often pelted with retaliation when they establish their operations or begin to promote their products aggressively. For example, Seven-Up launched Like Cola directly against Coke and Pepsi in 1982 in an effort to make inroads into the cola segment of the soft drink market. Without delay, the two major competitors responded with strong promotional campaigns, Like was withdrawn from the market, and Pepsi and Coke have dominated the cola market in the United States ever since. Hence, if prospective entrants anticipate a firm retaliation from existing firms, they are less likely to enter the industry in the first place. Retaliation is most likely to occur when incumbent firms are committed to remaining in the industry or have sufficient cash and productive capacity to meet anticipated customer demand in the future.²⁴

The likelihood that new firms will enter an industry is also contingent on the extent to which **barriers to entry** have been erected—often by existing competitors—to keep prospective newcomers out.²⁵ From a global perspective, many barriers have declined, as firms in countries like India and China make use of technology—and specifically a developing global fiber-optic network—to gain access to industries in the West. For example, as many as half a million U.S. Internal Revenue Service (IRS) tax returns are prepared annually in India. Hence, barriers are always changing as technology, political influences, and business practices also change.²⁶

The seven major barriers (obstacles) to entry are described in the following sections (see also Strategy at Work 2.1). As with intensity of rivalry, each factor should be assessed independently and then integrated into an overall perspective on entry barriers.



Strategy at Work 2.1: Creating Barriers to Entry in the Airline Industry²⁷

U.S. airline deregulation in 1978 was intended to encourage new start-up ventures and foster competition. For a while, it seemed to be working; new companies such as Southwest Airlines and AirTran (acquired by Southwest in 2011) helped to lower ticket prices significantly. Over time, however, the major airlines have succeeded in erecting enormous barriers to entry, such as the following:

1. The *global alliances* that exist among major world carriers result in substantial control over hubs and passenger-loading gates at large airports, where such carriers already typically hold 20- to 40-year leases. In addition, most airlines have a large number of U.S. hub airports, a feeder system to those hubs, and international routes that tie into the hubs. Such systems take decades and hundreds of millions of dollars to acquire.

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(Continued)

2. Major airlines own the computer reservation systems, negotiate commission arrangements with travel agents for bringing business to them, and charge small carriers hefty fees for tickets sold through those systems. By operating their own websites, U.S. airlines have been able to eliminate the commission fees paid for domestic bookings. Even the surviving online agencies like Travelocity, Orbitz, and Expedia must seek profits by packaging hotels and rental cars with airline tickets or by purchasing blocks of airline tickets on select flights far in advance to control the price.
3. All major carriers operate frequent-flyer programs that encourage passengers to avoid switching airlines. Many of the programs expire when a passenger does not fly on the airline after a specific period of time, often 3 years.
4. Airline computer-pricing systems enable them to selectively offer low fares on certain seats and to certain destinations (often purchased well in advance or at the last minute), thereby countering a start-up airline's pricing edge.
5. The dominant major carriers are willing to match or beat the ticket prices of smaller niche airlines and often respond to price changes within hours. Most are capable of absorbing some degree of losses until weaker competitors are driven out of business.

These barriers are designed to keep control of the airline industry's best routes and markets in the hands of a few carriers, even after two decades of deregulation. As such, newly formed carriers are often limited to less desirable routes. Although many upstarts fail in their first year or two of operation, others such as Southwest and JetBlue have been successful and are filling viable niches in the industry. Interestingly, the airline industry fallout from the events of 9/11 was felt the most by established competitors such as American Airlines and United Airlines.

Economies of Scale

Economies of scale refer to the decline in unit costs of a product or service that occurs as the absolute volume of production increases. Scale economies occur when increased production drives down costs and can result from a variety of factors, most notably high firm specialization and expertise, volume purchase discounts, and a firm's expansion into activities once performed at higher costs by suppliers or buyers. Economies of scale exist in most industries but to different extents. Substantial economies of scale deter new entrants by forcing them either to enter an industry at a large scale—a costly course of action that risks a strong reaction from existing firms—or to suffer substantial cost disadvantages associated with a small-scale operation. For example, a new automobile manufacturer must accept substantially higher per-unit costs as a result of the massive investment required to establish a production facility unless a large volume of vehicles can be produced at the outset. In contrast, while a new restaurant can enjoy economies of scales by attracting a large number of customers early on, higher per-unit costs associated with a slow start are easier to overcome as long as the firm is able to achieve modest growth.

Brand Identity and Product Differentiation

Established firms may enjoy strong brand identification and customer loyalties that are based on *actual* or *perceived* product or service differences. Typically, new entrants must incur substantial marketing and other costs over an extended period of time to overcome this barrier. Differentiation is particularly important among products and services where the risks associated with switching to a competitive product or service are perceived to be high, such as

over-the-counter drugs, insurance, and baby-care products. The producer of a new toothpaste typically spends heavily to counter affinities to established brands like Colgate and Crest.

Capital Requirements

Generally speaking, higher entry costs tend to restrict new competitors and ultimately increase industry profitability.²⁸ Large initial financial expenditures may be necessary for production, facility construction, research and development, advertising, customer credit, and inventories. Some years ago, Xerox cleverly created a capital barrier by offering to lease, not just sell, its copiers. As a result, new entrants were faced with the task of generating large sums of cash to finance the leased copiers.²⁹ Of course, this barrier was short-lived. As the industry grew and technological advances lowered the cost of copiers, this barrier eroded.

Switching Costs

As previously discussed, switching costs are the upfront costs—financial and nonfinancial—that buyers of one firm's products may incur if they switch to those of a rival. If these costs are high, buyers may need to test the new product first, make modifications in existing operations to accommodate the change, or even negotiate new purchase contracts. When switching costs are low—typically the case when consumers try a new grocery store—change may not be difficult. Likewise, fast-food restaurants generally have little difficulty persuading consumers to switch from one restaurant to another—at least once—when products are introduced.

Access to Distribution Channels

In some industries, firms that wish to use existing distribution channels must entice distributors through price breaks, cooperative advertising allowances, or sales promotions. Existing competitors may have distribution channel ties based on long-standing or even exclusive relationships, requiring the new entrant to create its own channels of distribution. For example, a number of manufacturers and retailers have formed partnerships with FedEx or UPS to transport merchandise directly to their customers. As a distribution channel, the Internet may offer an alternative to companies unable to penetrate the existing channels.

Cost Advantages Independent of Size

Many firms enjoy cost advantages emanating from economies of scale. Existing competitors may have also developed cost advantages *not* associated with firm size that cannot be easily duplicated by newcomers. Such factors include patents or proprietary technology, favorable locations, superior human resources (HR), and experience in the industry. For example, eBay's experience, reputation, and technological capability in online auctions have made it very difficult for prospective firms to enter the industry. When such advantages exist for one or more existing competitors, prospective new entrants are usually hesitant to join the industry.

Government Policy

Governments often control entry to certain industries with licensing requirements or other regulations. For example, establishing a hospital, a nuclear power facility, or an airline cannot be done



in most nations without meeting substantial regulatory requirements. Although firms generally oppose government attempts to regulate their activity, this is not always the case. Existing competitors often lobby legislators to enact policies that increase costs because they also make entry into their industry a complicated or costly endeavor.

Pressure From Substitute Products

Firms in one industry often compete indirectly with firms in other industries that produce **substitute products**. By definition, substitute products are produced by firms in other industries; they satisfy similar consumer needs but differ in specific characteristics. It should be emphasized that products and services affected by a firm's competitors (i.e., companies in the same industry) do *not* represent substitutes for that firm. Substitutes always reside outside of a firm's industry.

Because substitutes are not part of the industry, they cannot be identified until the industry is defined clearly. For example, suppose the industry of McDonald's is defined specifically as fast food. Because Applebee's does not meet the criteria for inclusion in the industry—fast service, drive-thru service, easy-to-eat food, and the like—it would not be considered a substitute. If the industry of McDonald's is defined more broadly to include all restaurants, then Applebee's would meet the criteria. In this instance, Applebee's would be a rival, not a substitute.

Although they emanate from outside the industry, substitutes can influence demand patterns within the industry and can even limit the prices that firms can charge. For instance, low fares offered by airlines can place a ceiling on the long-distance bus fares that Greyhound can charge for similar routes. Hence, firms that operate in industries with few or no substitutes are more likely to be profitable.

Bargaining Power of Buyers

Firms in every industry must negotiate with both suppliers of required resources and buyers of the finished products or services. The buyers of an industry's outputs can lower that industry's profitability by bargaining for higher quality or more services and playing one firm against another. Levi Strauss discovered this when negotiating a sizeable contract with mega-retailer Wal-Mart. Ultimately, the famous American jean-maker decided to create a lower-cost brand by overhauling production and distribution efforts.³⁰

A number of circumstances can raise the bargaining power of an industry's buyers:

1. Buyers are concentrated, or each one purchases a significant percentage of total industry sales. If a few buyers purchase a substantial proportion of an industry's sales, then they will wield considerable power over prices. This is especially prevalent in markets for components and raw materials.
2. The products that the buyers purchase represent a significant percentage of the buyers' costs. When this occurs, price will become more critical for buyers, who will shop for a favorable price and will purchase more selectively.
3. The products that the buyers purchase are standard or undifferentiated. In such cases, buyers are able to play one seller against another and initiate price wars.
4. Buyers face few switching costs and can freely switch from one rival to another. Fast food is a prime example because consumers can readily switch among restaurants that are typically clustered together.
5. Buyers earn low profits, creating pressure for them to reduce their purchasing costs and negotiate more aggressively with industry firms. Producers of automobile parts

are often squeezed when profits decline among manufacturers.

6. Buyers can engage in backward integration by becoming their own suppliers. Large fast-food restaurants can purchase their own potato farms if they wish. Aware of this possibility, potato producers are under constant pressure to provide high-quality products and favorable terms.
7. The industry's product is relatively unaffected by the quality of the buyers' products or services, thereby creating an incentive for firms to change suppliers and demand the lowest prices. When companies purchase bottled water for office consumption, price is a key component. In contrast, when the quality of the buyers' products is greatly affected by what they purchase from the industry, buyer power is reduced because quality and special features will be the most important characteristics.
8. Buyers have access to the same product, market, and cost information as producers in the industry. The more information buyers have regarding demand, actual market prices, and supplier costs, the greater their ability to play one against another. The Internet has increased the quantity and quality of information available to buyers in a number of industries.



Bargaining Power of Suppliers

The *tug of war* between an industry's rivals and their suppliers is similar to that between the rivals and their buyers. When suppliers to an industry wield collective power over the firms in the industry, they can siphon away a portion of excess profits that may be gleaned. Alternatively, when an industry's suppliers are weak, they may be expected frequently to cut prices, increase quality, and add services. This was the case among U.S. automakers during the 1990s and 2000s.³¹

The struggle between U.S. service stations and their suppliers—big oil companies—is another interesting example. When the popularity of E85 ethanol—a mixture containing 85% ethanol and 15% gasoline—began to rise in the mid- to late 2000s, many U.S. service stations were prohibited from carrying the alternative fuel. Oil companies that do not supply E85 lose sales every time a driver fills his tank with the ethanol mix. As a result, many prohibit their franchisees from carrying fuel from other producers. Service stations that are allowed to carry E85 are often required to dispense it from a pump on a separate island not under the main canopy, which is a costly endeavor. Because there are only a few major oil companies and thousands of service stations in the United States, the oil companies are able to wield most of the power.³²

The conditions that make suppliers powerful are similar to those that affect buyers because negotiations are similar in both instances. Specifically, suppliers are powerful under the following circumstances:

1. The supplying industry is dominated by one or a few companies. Concentrated suppliers typically exert considerable control over prices, quality, and terms when selling to fragmented buyers. This is especially true when a monopoly—one dominant producer—exists.

2. There are no substitute products, weakening an industry's rivals in relation to their suppliers. Automobile producers must purchase tires; there are no alternatives. Other factors equal, this reality gives power to the tire manufacturers.
3. The industry as a whole is not a major customer of the suppliers. If a particular industry does not represent a significant percentage of the suppliers' sales, then the suppliers control the balance of power. If competitors in the industry comprise an important customer, however, suppliers tend to understand the interrelationships and are likely to consider the long-term viability of their counterparts—not just price—when making strategic decisions.
4. The suppliers pose a credible threat of forward integration by “becoming their own customers.” If suppliers have the ability and resources to distribute their own products and operate their own retail outlets, they will possess considerable control over buyers. Many producers have exerted this control by selling directly to consumers.
5. The suppliers' products are differentiated or have built-in switching costs, thereby reducing the buyers' ability to play one supplier against another. In such instances, firms have little or no choice but to purchase the products, regardless of price or other terms.

Limitations of Porter's Five Forces Model

Generally speaking, the five forces model is based on the assumptions of the IO perspective on strategy, as opposed to the resource-based perspective. Although the model serves as a useful analytical tool, it has several key limitations. First, it assumes the existence of a clear, recognizable industry. As complexity associated with industry definition increases, the ability to draw coherent conclusions from the model diminishes. Likewise, the model addresses only the behavior of firms in an industry and does not account for the role of partnerships, a growing phenomenon in many industries. When firms “work together,” either overtly or covertly, they create complex relationships that are not easily incorporated into industry models.

Second, the model does not take into account the fact that some firms, most notably large ones, can often take steps to modify the industry structure, thereby increasing their prospects for profits. For example, large airlines have been known to lobby for hefty safety restrictions to create an entry barrier to potential upstarts. Mega-retailer Wal-Mart even employs its own team of lobbyists in Washington, D.C.

Third, the model assumes that industry factors, not firm resources, comprise the primary determinants of firm profit. This issue continues to be widely debated among both scholars and executives.³³ This limitation reflects the ongoing debate between IO theorists who emphasize Porter's model and resource-based theorists who emphasize firm-specific characteristics. The resource-based perspective is addressed later in the strategic management process.

Finally, a firm that competes in many countries typically must analyze and be concerned with multiple industry structures. The nature of industry competition in the international arena differs among nations and may present challenges that are not present in a firm's host country.³⁴ One's definition of the industry of McDonald's may be limited to fast-food outlets in the United States but may also include a host of other traditional restaurants when other countries are considered. Different industry definitions for a firm across borders can make the task of assessing industry structure quite complex.

These challenges notwithstanding, a thorough analysis of the industry via the five forces model is a critical first step in developing an understanding of competitive behavior within an industry.³⁵ In a general sense, Porter's five forces model provides insight into profit-seeking opportunities, as well as potential challenges, within an industry (see Case Analysis 2.2).



Case Analysis 2.2 Step 3: Potential Profitability of the Industry

Porter's five forces model should be applied to the industry environment—as identified in the previous step—by examining threat of entry, rivalry among existing competitors, pressure from substitute products, and the bargaining power of buyers and suppliers. Each of the specific factors identified in the rivalry and new entrants sections should be assessed individually. In addition, each of the five forces should be evaluated with regard to its positive, negative, or neutral effect on potential profitability in the industry. In most instances, both positive and negative influences will be identified. An overall assessment that considers the composite effect of all five forces should also be provided. This assessment identifies the industry as profitable, unprofitable, or somewhere in between.

Step 4: What Firms Have Succeeded and Failed in the Industry, and Why? What Are the Critical Success Factors?

Every industry has recent winners and losers. To understand the CSFs, one must identify the companies that are doing well, as well as those that are doing poorly, and determine whether their performance levels appear to be associated with similar factors. For example, McDonald's, KFC, and Taco Bell are long-term successful players in the fast-food industry, while rival Arby's has struggled. Are there any common factors that may help explain the differences in performance? Consider that many analysts have noted that consistency and speed of service are CSFs in the fast-food industry. Indeed, McDonald's, KFC, and Taco Bell are all noted for their fast, consistent service.

Several key CSFs can usually be identified by studying an industry's history. Examples of success and failure should be identified and used as a basis for identifying CSFs. A business may succeed even if it does not possess a key industry CSF, although this is the exception, not the rule. Chipotle Mexican Grill, for example, has become a highly successful fast-food chain without displaying its products, advertising on television, franchising, or constantly cutting costs—all factors one might consider to be CSFs in the fast-food industry.³⁶ However, the *likelihood* of success is diminished greatly when a business does not possess a CSF.

Summary

An industry is a group of companies that produce similar products or services. Industries tend to progress through readily predictable life cycle stages. Michael Porter has identified five basic competitive industry forces that can ultimately influence profitability at the firm level: (1) intensity of rivalry among incumbent firms in the industry, (2) the threat of new entrants in the industry, (3) the threat of substitute products or services, (4) bargaining power of buyers of the industry's outputs, and (5) bargaining power of suppliers to the industry. Firms tend to operate quite profitably in industries with high-entry barriers, low intensity of competition among member firms, no substitute products, weak buyers, and weak suppliers. These relationships are tendencies, however, and do not mean that all firms will perform in a similar manner because of industry factors. Although Porter's model has its shortcomings, it represents an excellent starting point for positioning a business among its competitors.

Key Terms

Barriers to Entry: Obstacles to entering an industry, including economies of scale, brand identity and product differentiation, capital requirements, switching costs, access to distribution channels, cost disadvantages independent of size, and government policy.

Critical Success Factors (CSFs): Elements of the strategy that are essential for success among most or all competitors within a given industry.

Exit Barriers: Economic, strategic, or emotional obstacles to leaving an industry.

Herfindahl-Hirschman Index (HHI): A sophisticated measure of market concentration calculated by summing the squares of the market shares for each firm competing in an industry.

Hypercompetition: The notion that industries emerge, develop, and evolve so rapidly that identifying the current life cycle stage may be neither possible or worthwhile.

Industry: A group of competitors that produces similar products or services.

Industry Life Cycle: The stages (introduction, growth, shakeout, maturity, and decline) through which industries are believed to pass.

Market Share: The percentage of total market sales attributed to one competitor (i.e., firm sales divided by total market sales).

Relative Market Share: A firm's share of industry sales when only the firm and its key competitors are considered (i.e., firm sales divided by sales of the key firms in the industry).

Substitute Products: Alternative offerings produced by firms in another industry that satisfy similar consumer needs.

Switching Costs: One-time costs that buyers of an industry's outputs incur as they switch from one company's products or services to another's.

Review Questions and Exercises

1. Visit the websites of several major restaurant chains. Identify the industry(s) in which each one operates. Would you categorize them in the same industry or in different industries (e.g., fast food, family restaurants)? Why or why not?
2. Identify an industry that has low barriers to entry and one that has high barriers. Explain how the difference in entry barriers influences competitive behavior in these industries.
3. Identify some businesses whose sales have been adversely affected by substitute products. Why has this occurred?
4. Identify an industry in which the suppliers have strong bargaining power and another industry in which the buyers have most of the bargaining power. How does this affect potential profitability in the industries?

Practice Quiz

True or False?

1. A firm always operates in a single, distinct industry.
2. All industries follow the stages of the industry life cycle model.
3. The likelihood that new firms will enter an industry is contingent on the extent to which barriers to entry have been erected.
4. Higher capital requirements for entering an industry ultimately raise average profitability within that industry.
5. Substitute products are produced by competitors in the same industry.
6. A key limitation of Porter's five forces model is its reliance on resource-based theory.

Multiple Choice

7. Industry growth is no longer rapid enough to support a large number of competitors in _____.
 - A. growth
 - B. shakeout
 - C. maturity
 - D. decline
8. The intensity of rivalry among firms in an industry is dependent on _____.
 - A. concentration of competitors
 - B. high fixed or storage costs
 - C. high exit barriers
 - D. all of the above
9. The decline in unit costs of a product or service that occurs as the absolute volume of production increases is known as _____.
 - A. production effectiveness
 - B. effective operations management
 - C. economies of scale
 - D. technological analysis
10. When switching costs are high, _____.
 - A. customers are less likely to try a new competitor.
 - B. companies spend more on technology.
 - C. companies seek new suppliers to reduce costs.
 - D. none of the above
11. Which of the following is not a cost advantage independent of scale?
 - A. proprietary technology
 - B. favorable locations
 - C. experience in the industry
 - D. high volume of production
12. What is occurring when those who purchase an industry's goods and services exercise great control over pricing and other terms?
 - A. a high bargaining power of suppliers
 - B. a low bargaining power of suppliers
 - C. a balance of power among suppliers
 - D. none of the above

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Strategy + Business Reading

Focus and Scale on the Internet

The next wave of online business models must focus narrowly, rather than blindly pursuing scale.

by Tim Laseter

During the early days of the Internet, popular wisdom highlighted the power of the new virtual business model that could reach a mass market without the bricks-and-mortar constraints of the “old economy.” Venture capitalists threw money at the lucky startups and encouraged them to get big fast before competitors could gain a foothold. Operating strategies were all about “scalability.” Although that model worked fine for a few companies, like Amazon and eBay, it proved a dead end for most. Today a simplistic approach built around mass markets and scalability is a near-certain recipe for failure.

That’s not to say that we won’t continue to be amazed by growth phenomena—like Facebook and Google—that expand quickly by creating fundamentally new business models. But most Internet businesses are simply offering a new twist on an old business idea and, accordingly, seek to displace existing companies. No longer expecting every new idea to transform the old economy, entrepreneurs (and even venture capitalists) are beginning to realize that scale is the result—not the cause—of business success.

A careful look at some past successes and failures as well as a few emerging Internet stars reveals that a clear focus on distinct capabilities has led to success. And, perhaps surprisingly, the old model of mass-market scalability is being turned on its head by a new local focus. Instead of using the virtual nature of the Internet to reach a geographically unconstrained mass market, new companies are building distinct capabilities at a local level to attract loyal customers. Those capabilities—not scale—provide the barriers to entry that allow these companies to outperform their competitors. Much as in the old economy, leading Internet businesses are gaining scale by replicating their success rather than pursuing scale as the key to success.

The Fallacy of Scale in B2B

An examination of “B2B e-marketplaces”—a class of early Internet companies that sought to transform business-to-business transactions—demonstrates the fleeting value of scale and the virtual enterprise. Consider FreeMarkets Inc., founded in 1995, which offered to save companies up to 15 percent on their purchases through the use of online auctions. FreeMarkets used the Internet to help its clients tap a broader range of suppliers and create more competitive market dynamics through real-time feedback showing the latest price reduction. Over the course of a few hours, the clients confidently discovered the absolute rock-bottom prices by pushing every supplier to its “walk away” point. The traditional methods of issuing requests for quotes, then conducting multiple rounds of negotiations with a narrow list of candidates, took far longer and often left money on the table for the supplier to claim. The success FreeMarkets achieved led to a December 1999 initial public offering (IPO) that raised nearly US\$200 million at a stock price of \$48 per share. By the end of the opening day, the price had skyrocketed to close at \$280 per share, which valued the company at a staggering \$8 billion, despite its having revenues of only \$13 million in the first nine months of that year.

Not surprisingly, the big industrial customers using the online auction services of the startups concluded that owning a B2B e-marketplace could be worth even more than the savings from the auctions. General Motors Company, which had accounted for 17 percent of the revenues earned by FreeMarkets during the nine months prior to the IPO, announced a consortium with rivals Ford Motor Company and Daimler-Chrysler AG just months later, in early 2000. The new entity, Covisint, would offer online auctions to its members and would also automate

information sharing and a host of transactions among the Detroit Three automakers and their suppliers. The virtual scale of FreeMarkets was quickly trumped by the actual scale of existing players.

But the massive complexity costs of collectively redesigning the critical interfaces among all the vehicle manufacturers and hundreds of suppliers swamped the anticipated benefits of economies of scale. As the Internet bubble burst, the auto companies realized that each of them worked with suppliers in different ways and had little desire to standardize, especially because each had the scale to develop its own Internet software tools independently. FreeMarkets then acquired the auction services business line of Covisint in 2003 before being subsumed under Ariba Inc. in 2004. Also in 2004, the collaborative software tools developed by Covisint were sold to the Compuware Corporation, which repurposed the software for a broader set of smaller companies that lacked the scale to develop their own tools.

So much for using the Internet to fundamentally transform the staid industries of the old economy. Maybe scale was not all it was cracked up to be.

Scale in Internet Retailing

But perhaps FreeMarkets and even e-marketplaces in general were simply flawed business models. Or maybe the business-to-business market suffers from too much inertia to allow a startup to succeed. After all, Amazon and eBay offer great models of success in the business-to-consumer (B2C) market, even though B2B mostly offers Internet failures.

True, Amazon, a “pure play” startup founded in 1994, has come to dominate online retailing. With \$34 billion in 2010 sales, Amazon is 2.5 times bigger than the second-largest online retailer and more than 70 times the size of the 50th-ranked one. Although a powerful example, Amazon’s success needs to be put into context: Online retail sales account for less than 4 percent of total retail in the United States. So Amazon may appear to be a big fish, but it is really just a medium-sized fish in a relatively small pond compared with the ocean of total global retail. The next 10 companies on the list of the top 500 Internet retailers as published by *Internet Retailer* magazine all existed well before the World Wide Web came to our offices and homes, and have more sales in total than Amazon. Big-box office-supply retailers Staples, Office Depot, and OfficeMax take up three of those 10 slots. And although the online channel accounted for less than 1 percent of its total sales, Walmart garnered sixth place. Even the perennially troubled Sears made the top 10 by channeling 6.3 percent of its \$44 billion in sales through the Internet. You have to drop to 12th place to find another pure-play online retailer, Newegg, a purveyor of computer hardware and software that was founded in 2001. Netflix, founded in 1997 and 14th on the list, offers another example of a company launched on the promise of the Internet. However, Newegg, Netflix, and Amazon are the only three nontraditional retailers in the top 25.

The vast majority of the pure-play startups that sought to dominate the mass market proved to be spectacular failures. One of the earliest flameouts, Value America Inc., offers a classic case of unbridled pursuit of scale. Founded in 1996 and funded by such heavyweights as FedEx founder Fred Smith and Vulcan Capital (the venture company of Microsoft cofounder Paul Allen), the company sought to sell anything and everything online. Value America used the deep pockets of its investors to buy full-page advertisements in *USA Today*. At the end of its first day of trading as a public company in April 1999, the company achieved a valuation of \$2.4 billion; it filed for bankruptcy a mere 16 months later, in August 2000.

Webvan Group Inc. similarly sought to be a one-stop shop by delivering everything to the consumer’s door. Funded by a record-breaking \$400 million in four rounds of venture capital financing, Webvan launched operations in Oakland, Calif., in June 1999. By the end of the year, it had raised another \$400 million to initiate nationwide expansion in the form of 26 additional distribution centers, each carrying a price tag of \$35 million. But revenues did not come as quickly as expected. Rather than meeting the projections to generate positive cash flow in five quarters, the Oakland facility was operating at less than 30 percent capacity utilization at the end of 2000. By the spring of 2001, Webvan was losing \$100 million per quarter and its stock price had dropped from a high of \$34 at its initial public offering to less than 30 cents. It shut down in July 2001, just over two years after it began online operations.

Amazon may appear to be a lucky exception, but in reality it built its scale via a combination of an initially narrow focus and a major investment in unique capabilities. Although Jeff Bezos chose the name *Amazon* as a nod to

the world's most voluminous river, with a vision of being Earth's biggest store, he started by focusing on the inefficient supply chain of bookselling. From this base, Bezos invested in technology and operational capabilities that would provide a source of competitive advantage. Amazon's website defined the standards for online shopping convenience, with innovations such as its patented one-click shopping feature. Unlike other startups, Amazon did not seek to outsource fulfillment, but instead sought to become the industry leader by continuously investing in and improving this critical capability. Not until 1999—five years after the company was launched—did Bezos make the claim (publicly and audaciously, in a *Time* magazine article) that Amazon fulfillment centers were being designed to handle “Anything, with a capital A.”

Lessons in Focus

Amazon has gained scale through its success rather than seeking scale as the key to success. In doing so, it followed a path similar to that of Walmart, the dominant mass-market player of traditional retailing. As the world's largest company, Walmart certainly benefits from scale economies, but it did not become the world leader because of a scale advantage. When Sam Walton opened his first Walmart in 1962, he had already spent 17 years learning about retail. His new chain built discount stores in smaller, underserved cities and towns in the southern United States. It took 30 years of steady growth for Walmart to pass the then-dominant discounters, Kmart in 1990 and Sears in 1992. Walmart's revenues now total \$419 billion, nearly 10 times the combined sales of those formerly dominant rivals, which now operate as the Sears Holdings Corporation after a survival merger in 2005.

Many of the recent success stories of the Internet demonstrate the value of focus over scale. Two of the best examples are Zappos.com Inc. and Quidsi Inc., both high-profile acquisitions by Amazon over the last two years. In 2009, Amazon closed a \$1.2 billion acquisition of Zappos, its biggest deal ever. Zappos, founded in 1999, focuses on shoes, a tough category to sell on the Internet because customers want to try shoes on to ensure proper fit, and they often return them. So Zappos focused not only on shoes, but more importantly on building a set of capabilities to attract and retain loyal customers. (See “At Zappos, Culture Pays,” by Dick Richards, *s+b*, Autumn 2010.) Under the leadership of CEO Tony Hsieh, the company moved its headquarters to Las Vegas in 2004 because of difficulty finding good customer service staff in San Francisco. Las Vegas already had a large call-center industry and a 24-hour-a-day culture fitting for an online business. But Zappos also rewrote the rules of the typical call center to build a capability far different from the traditional mass market–focused model of other online retailers. Amazon tries to encourage customers to interact through the Web rather than the phone, whereas Zappos encourages members of its “customer loyalty team” to connect emotionally with the customer whenever possible. Team members are not measured on call productivity—that is, how quickly they can process a customer and get off the phone. Instead, company lore celebrates the record for the longest call with a single customer, now standing at around eight hours.

Zappos cares about cost—one of its 10 core values is “Do more with less.” But according to VP of Merchandising Steve Hill, “We price competitively, but we do not compete on cost. That's not the way to attract loyal customers.” Zappos has nurtured those loyal customers to drive the growth of a \$4.3 billion online shoe market—and come to dominate it. Amazon was losing the game in the category despite its industry leadership and the extensive shoe offering on its main store and through a separate website, Endless.com, which it launched in 2007. The Zappos focus on customer loyalty was trumping Amazon's cost-based, mass-market model.

In November 2010, Amazon announced another large acquisition: Quidsi, the parent company of Diapers.com and Soap.com. Again, both sites sold products that Amazon already offered online. But Quidsi was succeeding by building capabilities focused tightly on the needs of its core customer base: busy new parents. It now hopes to grow by following the evolving needs of this clear demographic segment.

Focus on Local Capabilities

The latest trend on the Internet takes to the extreme a focus on capabilities rather than scale. Instead of seeking to serve the mass market from a virtual node on the Internet, independent of geography, companies are starting to

leverage the Internet at a local level, turning the scale-based model on its head—and perhaps putting the final nail in the coffin of the original Internet model.

Consider one of the latest phenoms, Groupon, which captured headlines in December 2010 by rejecting a \$6 billion offer from Google. Groupon started in Chicago in November 2008 and quickly expanded to Boston, New York City, and Toronto. In 2010, it expanded to nearly 500 new markets in North America and Europe, a staggering pace of nearly 10 cities per week.

A fairly simple concept has fueled this phenomenal growth. In each of its 500 markets, Groupon offers a “daily deal” that taps the marketing dollars of local businesses (a market in which Google has struggled). Consumers in the local market see promotional discounts from local merchants ranging from 50 to 90 percent off. Unless a predefined number of Groupon customers make a purchase, the deal does not “tip”; no one gets the bargain and the merchant pays nothing to Groupon. But the need to tip the deal encourages buyers to solicit their network of friends and family members to join the deal directly or through various social media such as Facebook. By early 2011, the company had offered more than 100,000 deals in partnership with 58,000 local businesses.

Groupon certainly gains scale economies by serving so many locations, and the model has strong network effects. It boasts more than 50 million subscribers, which obviously attracts merchants interested in offering deals. But most deals are local and, accordingly, the relevant number for most merchants is not the 50 million subscribers but instead the number of local subscribers.

To ensure successful execution, Groupon uses the Internet and its global scale to attract customers through mass-market advertising. But it also has to ensure its deals will appeal to its local customer base by vetting the local merchants in each city. Groupon has developed deep capabilities for identifying targeted merchants within priority cities, and it turns down the vast majority of the proffered merchant deals. With a promise of at least one deal a day in each city served, the company must have an effective and efficient set of routinized processes for working at the local level.

Some lesser-known examples of the emerging local focus are beginning to attract the attention of venture capitalists. Like Amazon before it, J. Hilburn—a Dallas-based startup—seeks to disintermediate an inefficient supply chain used by traditional local players. Founded in 2007, J. Hilburn offers custom-tailored clothing made from high-quality fabric, but at a price within the reach of most business professionals. The company makes use of the Internet to eliminate both the need to hold inventory and the risk of unsold products by procuring to order along a focused supply chain. In 2010, the company sold 60,000 custom-tailored shirts made from Italian fabric at its factory outside Macau, China, at prices ranging from \$80 to \$150 each.

To offer custom-made shirts, the company needs a local capability, provided by a network of “style advisors” who go to a client’s home or office to take tailoring measurements. As is the case in other direct-sales businesses, the style advisors receive a commission on their own sales as well as on the sales of other advisors they recruit to their network. J. Hilburn currently employs more than 500 style advisors, typically women with school-age children seeking extra income. Although potential customers can visit the company’s website to initiate the purchase process, a search for the name of a style advisor is limited to a maximum of 30 miles from a given zip code. Despite the importance of its virtual model, building the local network remains key to J. Hilburn’s ability to fully leverage its Internet-enabled supply chain.

The clearest example of turning the old model on its head can be found in the grocery industry and the infamous “last mile” terrain that Webvan sought to tackle with the “get big fast” model of scalability and a mass-market focus. (See “The Last Mile to Nowhere: Flaws & Fallacies in Internet Home-Delivery Schemes,” by Tim Laseter, Pat Houston, Anne Chung, Silas Byrne, Martha Turner, and Anand Devendran, *s+b*, Third Quarter 2000.) Unlike Webvan—or even the largely successful FreshDirect—Retail Relay Inc. seeks to minimize capital investment and avoid the pursuit of scale economies and mass-market consumers by building uniquely local capabilities. Founded in 2007, the company offers online grocery shopping in Charlottesville and Richmond, Va., in partnership with local retailers, farmers, and employers through its website, RelayFoods.com. (Disclosure: I have served as an advisor to Relay since its founding.) The site offers more than 15,000 items in each city from a combined network of roughly 90 local farms and stores, and taps into the food movement popularized by Michael Pollan in the *New York Times* bestseller *The Omnivore’s Dilemma: A Natural History of Four Meals* (Penguin Press, 2006). Instead of targeting major metropolitan markets, Relay scales its operations to smaller cities and towns. It can afford to serve these less-dense populations by offering a mix of pickup locations throughout the area rather than seeking to serve all customers through a home delivery model.

Like Zappos and Quidsi, the company does not seek the generic mass-market customer but instead focuses on a particular demographic—in this case, time-strapped “locavores”—that it can serve with a superior business model and turn into loyal customers. Relay views its ties to the local community as its competitive barrier to entry.

The Relay model stands in stark contrast to the failed models of the past as well as the current competition. Amazon also launched an experiment in online grocery, Amazon Fresh, in 2007. Although it is well aware of the challenges faced by Webvan and other online grocers, Amazon cannot ignore groceries, which represent a huge portion of total retail sales, if it expects to be Earth’s biggest store. Doug Herrington, the company’s VP of consumables, told *Bloomberg* magazine in September 2009, “We have a lot of confidence in the long-term economics. For a significant portion of the population, they’re going to find that the convenience, selection and pricing of online grocery shopping is going to be really compelling.”

Although the thin margins and operational complexity in grocery have constrained Amazon from extending its pilot efforts beyond Seattle and London, no pure-play Internet retailer is better positioned for the challenge of precise, cost-effective delivery. Amazon can leverage its technological and operational expertise in a scale-based model once the market reaches the necessary size. Similarly, online grocer Peapod, founded in 1989, can leverage the existing footprint and scale of its parent, the \$39 billion, Netherlands-based global grocer Royal Ahold NV, which operates hundreds of supermarkets in the U.S., including the Stop & Shop and Giant chains.

Execution Matters

Focusing on developing loyal customers and unique, local capabilities does not guarantee success on the Internet. Companies must inevitably fend off the competition by executing their strategies well. In September 2010—about halfway between its first and second funding rounds in Groupon—Battery Ventures founder Rick Frisbie told the *Wall Street Journal*, “I’m still not absolutely convinced that Groupon will be the kind of success we hope it will be.” He went on to explain that the company faces immense competition and a potentially indefensible position despite its current dominant market leadership.

Consider even the highly lauded Facebook. It leveraged its eye-popping growth rate to attract investors to fund investments in capabilities that attracted more and more users, which in turn attracted more investors, and, finally, some advertising revenue. Facebook has such a large base of users that it can help advertisers seek tightly focused customer segments. But now that Facebook has provided a blueprint, could a new competitor focus on a specific segment and steal those advertising dollars? Unlike the loyal customers of a Zappos or a Quidsi, the mass market can be quite fickle. As a reminder, Facebook CEO Mark Zuckerberg, who was named *Time*’s Person of the Year for 2010, might want to think about past magazine covers featuring the CEOs of what *Time* described as famous Web flameouts: Friendster, Napster, and Pets.com. Groupon founder Andrew Mason reportedly keeps these on display alongside his own *Forbes* cover in his Chicago headquarters, as a constant reminder that competitive advantage can be fleeting and that scale isn’t everything.

For most aspiring Internet entrepreneurs in today’s online environment, the most likely paths to success will start with focus, build on success, and then—and only then—lead to scale.

Author’s Note: A host of collaborators have helped discern the evolving trends on the Internet, including former Booz & Company colleagues Barrie Berg, Silas Byrne, Chris Capers, Anne Chung, Anand Devendran, David Evans, Pat Houston, Angela Huang, Brian Long, David Torres, and Martha Turner. More recently, academic collaborators Ken Boyer, Brent Goldfarb, David Kirsch, Eve Rosenzweig, Aleda Roth, Johnny Rungtusanatham, and, especially, Elliot Rabinovich have helped shape my thinking.

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