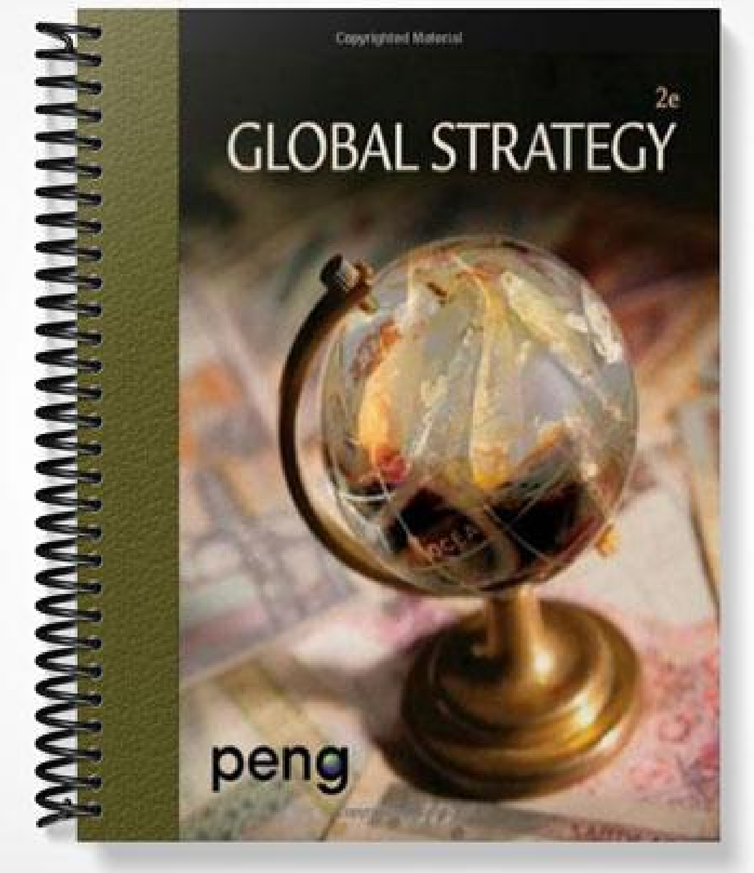
SOLUTIONS MANUAL



CHAPTER 2 – MANAGING INDUSTRY COMPETITION

CHAPTER OUTLINE

1. OPENING CASE: *THE AUTOMOBILE INDUSTRY – FROM GOOD LIFE TO BLOODBATH AT THE TOP*

a. Primary industry segments
   1) Mass market
      (a) Many competitors
      (b) Intense competition – price-cutting, incentives needed to induce purchase
      (c) Low profit margins
   2) Luxury market
      (a) Fewer competitors than in mass market
      (b) Less use of incentives and price cuts to induce purchase
      (c) Healthier profit margins than in mass market segment
   3) Ultra luxury market
      (a) Little competition in the past – but that is changing
      (b) Small number of cars produced each year – but they are very expensive

b. Recent phenomenon
   1) A number of car makers are entering the lucrative ultra luxury segment
   2) Supply of ultra luxury models is expected to grow
   3) Competition at the top will intensify

2. DEFINING INDUSTRY COMPETITION

a. Industry – group of firms producing goods and/or services that are similar to each other

b. Theories of industry competition
   1) Perfect competition:
      (a) Price set by the market
      (b) All firms are price takers
      (c) Entry and exit are fairly easy
      (d) Rarely observed in real world
   2) Industrial organization (IO) economics model
      (a) Industry structure determines firm conduct (strategy), which determines firm performance (SCP model)
      (b) Original goal – help regulators set policy to minimize ability of firms to earn excess profits
      (c) Strategists use the IO model to try to earn above-average returns (excess profits)

3. THE FIVE FORCES FRAMEWORK

a. From Economics to Strategy
   1) 1980 – Michael Porter translated and extended the Structure-Conduct-Performance (SCP) model of IO Economics to strategic management
   2) Key proposition – firm performance depends on industry structure, that is, the strength of the five forces

b. First force: Intensity of Rivalry Among Competitors

1) Key indicators of intense rivalry – threatens firms by reducing profits
   (a) Frequent price wars
   (b) Proliferation of new products
   (c) Intense advertising campaigns
   (d) High cost competitive actions and reactions
2) Conditions that lead to intense rivalry
   (a) Number of competitors
   (b) Similarity of firms in terms of size, market influence and product offerings
   (c) Products are big ticket items and purchased infrequently – makes it hard for one firm to dominate
   (d) New capacity must be added in large increments – creates over capacity which leads to price cutting
   (e) Slow industry growth or decline in demand
   (f) High exit costs – investment in specialized assets may prevent exit

c. Second force: Threat of Potential Entry
   1) Incumbents create entry barriers to keep new entrants out
      (a) Scale-based low cost advantages
         (i) Economies of scale
         (ii) Experience curves
      (b) Non-scale based low cost advantages
         (i) Proprietary technology
         (ii) Know-how
         (iii) Favorable access to raw materials and distribution channels
         (iv) Favorable locations
      (c) Product proliferation to leave little unmet demand
      (d) Product differentiation – uniqueness of products that adds value for customers
         (i) Brand identification
         (ii) Customer loyalty
            (i) Substantial switching costs
            (ii) Network externalities
         (iii) Possible retaliation by incumbents – made possible by excess capacity
      (e) Government policy and regulation

d. Third force: Bargaining Power of Suppliers – ability to raise prices and/or reduce quality
   1) Dominance of supplier industry by a few firms
   2) Suppliers provide unique, differentiated products with few or no substitutes
   3) Focal firm is not an important customer
   4) Willingness and ability of suppliers to integrate forward

e. Fourth force: Bargaining Power of Buyers – ability to reduce prices and/or increase quality
   1) Small number of buyers
   2) Products of the industry do not produce clear cost advantages or enhance the quality of life for buyers
   3) Purchase standard, undifferentiated commodity products from suppliers
   4) Willingness and ability of buyers to integrate backward

f. Fifth force: Threat of Substitutes – products from different industries that satisfy customer needs being met by focal firms
   1) Substitutes are superior to existing products in terms of quality or functionality
   2) Low switching costs

g. Lessons from the Five Forces Framework

1) Not all industries are equal in terms of profit potential. The pharmaceutical industry is likely to remain more profitable than the airline industry.
2) Strategists should evaluate the opportunities and threats underlying each competitive force to estimate the likely profit potential of the industry
3) Use the five forces model as an industry positioning tool
4) Core features of the five forces model remain remarkably insightful when analyzing new phenomena, such as e-commerce

4. THREE GENERIC STRATEGIES – Can strengthen focal firm's position relative to the five forces

a. Cost Leadership
   1) Firm's theory about how to compete successfully centers on low costs and low prices
   2) Offer better value to customers
   3) Target average customers for mass market – little differentiation
   4) Key functional areas are manufacturing and materials management
   5) High volume, low margin approach
   6) Defense against five forces
      (a) Charge lower prices, earn higher profits than higher cost rivals
      (b) Low cost advantage is barrier to entry
      (c) Reduces power of suppliers due to high volume purchased
      (d) Less affected by price increases by powerful suppliers or price concessions demanded by powerful buyers
      (e) Challenges substitutes to offer better utility and better prices
   7) Drawbacks to cost leadership
      (a) Danger of being out-competed on costs
      (b) Relentless drive to cut costs might compromise value that customers desire

b. Differentiation
   1) Deliver products that customers perceive to be valuable and different
   2) Target customers in smaller, well-defined segments who are willing to pay premium prices
   3) Low volume, high margin approach
   4) Differentiated products must have unique attributes (actual or perceived) – quality, sophistication, prestige, or luxury
   5) Challenge – identify attributes that are valued by customers in each market segment
   6) Key functional areas are research and development (source of innovations), marketing/sales and after-sale services
   7) Defense against five forces
      (a) Less resemblance to rivals affords greater protection from five forces
      (b) Ability to pass on suppliers' price increases to buyers
      (c) Strong brand loyalty mitigates buyer power
   8) Drawbacks to differentiation
      (a) Difficult to sustain basis of differentiation in the long run
      (b) Relentless efforts of competitors to duplicate differentiation

c. Focus
   1) Serves the needs of a particular segment or niche of an industry
   2) Segments can be defined by geographical market, type of customer, or product line
   3) Needs of niche/segment are so unique that broad-based competitors choose not to serve them or are not able to do so.
   4) A focused firm is either a specialized differentiator or a specialized cost leader
   5) Defends against five forces in same ways as differentiation or cost leadership

d. Lessons from the Three Generic Strategies
    1) Essence – choose whether to perform activities differently than rivals or to perform different activities than competitors
    2) Cost and differentiation are two fundamental strategic dimensions
    3) Performance of firms that are stuck in the middle may suffer

5. DEBATES AND EXTENSIONS

a. Clear versus Blurred Boundaries of Industry
    1) Sometimes it is hard to determine the exact boundaries of an industry – e.g. telecommunications.

b. Threats versus Opportunities
    1) Strategic alliances are on the rise – reduce rivalry, encourage cooperation
    2) Intense rivalry provides impetus to constantly improve and innovate – makes firms more competitive in domestic and international markets
    3) Five forces model over-emphasizes threats and downplays opportunities

c. Five Forces versus A Sixth Force
    1) Related and supporting industries (complementors) are an additional force that can impact the competitiveness of an industry

d. Stuck in the Middle versus All-Rounder
    1) If a low-cost firm has already achieved the maximum efficient scale, they must turn to differentiation to distinguish themselves from competitors
    2) Flexible manufacturing technology has enabled firms to produce differentiated products at a low cost – mass customization may become the name of the game in the future

e. Industry Rivalry versus Strategic Groups
    1) In broadly defined industries, not every company competes against every firm
    2) There are often groups of firms that compete against each other
        (a) Strategic groups in auto industry – mass market firms, luxury firms, and ultra luxury firms
    3) Strategies of firms within a strategic group tend to be similar, so does their performance
    4) Controversial issues with strategic groups
        (a) Stability of strategic groups
        (b) Mobility barriers between strategic groups
        (c) Strategic group analysis requires large quantities of objective data – how useful is it when there is a paucity of data?

f. Integration versus Outsourcing
    1) Industry-based view recommends backward or forward integration as a way to defend against the power of suppliers and buyers
    2) Integration is very expensive – so it might make sense for firms to outsource instead
    3) Integration can reduce strategic flexibility
    4) Internal suppliers often lose competitiveness – cost and quality suffer
    5) Activities that are crucial to the core business should not be outsourced
    6) Supplier relationships that are too close may introduce rigidities, including loss of flexibility
    7) In Japan suppliers may become trusted members of the *keiretsu.* Instead of treating suppliers as adversaries, they are treated as collaboration partners

g. Industry-versus Firm- and Institution-Specific Determinants of Performance

1) Recent success of firms in unattractive industries suggests that there must be firm-specific resources and capabilities that determine firm performance
2) Industry-based view ignores the impact of industry history and institutions on firm performance

h. Making Sense of the Debates
   1) Porter’s five forces framework identifies relevant variables and questions to ask
   2) Other frameworks also add insight about competition and firm performance

6. THE SAVVY STRATEGIST

a. Industry-based view provides a systematic foundation for industry and competitor analysis

b. Industry-based view provides some answers to the four fundamental questions proposed in chapter one
   1) Why do firms differ?
      (a) Five forces in different industries lead to diversity in firm behavior
   2) How do firms behave?
      (a) Maximize opportunities and minimize threats presented by the five forces
   3) What determines the scope of the firm?
      (a) Examine the relative bargaining power of the focal firm compared to suppliers/buyers
      (b) Traditional view recommends integration – increases the scope of the firm
      (c) Recent work cautions against integration in favor of outsourcing
         (i) Focus on core activities
         (ii) Be willing to collaborate with suppliers/buyers, as well as competitors
   4) What determines the international success and failure of firms?
      (a) Industry specific characteristics (i.e. the five forces)

CHAPTER TWO - LECTURE NOTES AND TEACHING TIPS

SUMMARY OF THE OPENING CASE: *THE AUTOMOBILE INDUSTRY – FROM GOOD LIFE TO BLOODBATH AT THE TOP*

This opening case highlights some of the recent trends in the global automobile industry that have led a number of competitors (e.g. Mercedes, BMW, Lexus, Acura, Cadillac, and Jaguar) to consider moving into the lucrative ultra luxury market.

Teaching Tip: Ask students to respond to the following case discussion questions (Possible answers are included in italics):

What are some of the most significant problems/concerns confronting competitors in the automobile industry?

The case mentions a number of significant issues/problems, such as the worldwide recession, industry-wide overcapacity, declining sales revenues, intense competition, relatively low profit margins dues to price competition and the need to offer purchase incentives to customers – especially in the mass market segment, as well as the recent decision of some manufacturers to enter the ultra-luxury segment.
Students may also identify some issues that were not mentioned in the case, such as: volatility in the price of gasoline; concerns about pollution, emission standards, and depletion of the ozone layer; product safety and liability issues, etc.

What are some of the options available to automobile manufacturers as they try to respond to and deal with these industry-wide problems?

Actions that automobile companies have taken to respond to these challenges include offering huge rebates as incentives for customers to buy a particular brand and/or model; providing inexpensive financing options to make cars more affordable; offering new luxury models because they tend to have higher profit margins than mass market models; expansion into foreign markets (e.g. China); and entry into the growing ultra luxury segment. Students might also come up with options that were not mentioned in the case, such as: identify new ways to differentiate cars to make them more attractive and add value for customers; focus on reducing manufacturing costs in order to improve profit margins; allow customers to design their own vehicles via the Internet in an effort to reduce overcapacity (mass customization); reduce the number of models and options that are available – may help reduce operating costs for those firms pursuing a lower cost niche; offer additional incentives for repeat purchases – sort of a customer loyalty program; consider vertical integration or outsourcing in order to reduce costs; reduce production capacity by closing older, more inefficient manufacturing facilities; develop strategic alliances with other automobile manufacturers to develop new technologies – fuel cells, renewable energy sources, or lean manufacturing processes, etc.

DEFINING INDUSTRY COMPETITION

Sometimes students have difficulty grasping what the concept of industry means – they confuse an individual firm with an industry and vice versa. In addition, the term “industry structure” is particularly problematic. This difficulty has been exacerbated in recent years as the boundaries that separate one industry from another have become blurred. It is good to stop and highlight these terms, explaining what they mean, and what they do not mean (e.g. do not confuse industry structure with organization structure).

Teaching Tip: Select an industry with which students are familiar and ask them to identify companies that are competing in that industry. What are some of the products and services that those companies provide that make them members of the same industry?

THE FIVE FORCES FRAMEWORK

The five forces framework forms the basis for the industry-based view of strategy. It highlights five different industry forces that can impact the profit potential of any industry and make it difficult for firms to earn above average profits. The five forces framework provides insight into the opportunities and threats underlying each competitive force and why there are industry differences in profitability.

THREE GENERIC STRATEGIES

Porter also suggested that there are three main generic strategies (i.e. theories about how to compete successfully) that companies use to strengthen their position: cost leadership, differentiation, and focus.

The author suggests a number of challenges or criticisms of the industry-based view of strategy that was presented in this chapter. Each of these debates offers some valid questions about the ability of the industry-based view to explain all performance differences among firms. For example, in cases where it is difficult to clearly identify the boundaries of an industry (e.g. broadcast television industry, or telecommunication), strategists might not be able to accurately evaluate all of the factors that influence the strength of each force of competition. Likewise, when the boundaries between firms are blurred by the use of partnerships and strategic alliances, it may be difficult to pinpoint performance difficulties that are due to industry-specific factors. In addition, when companies work together, they might be able to better defend against the five forces and reduce the negative impact of industry structure on performance. Furthermore, as more firms use outsourcing instead of vertical integration, they will have to find other ways to defend against powerful suppliers and buyers.

Teaching Tip: In order to help students understand the strategic implications of these criticisms of the industry-based view, it might be helpful to ask students to work in small groups to find specific examples that illustrate or demonstrate the aforementioned criticisms. For example:

- Identify examples of industries in which boundaries are blurred. What are the common characteristics of these industries?

Students might select the cell phone industry and suggest that the boundaries are blurring. Many cell phones now offer portable features that used to be available only in PDAs, such as email, Internet access, calendars, spreadsheet capabilities, digital cameras, games, etc.

Regardless of the examples identified by students, they should be able to find a few common characteristics, such as the fact that companies in both industries satisfy similar customer needs, and that many of the same competitors compete in both industries. Another common characteristic is that the industries share similar technologies, distribution channels, and/or research and development capabilities. Furthermore, as the boundaries between industries continue to blur, there will probably be some consolidation as firms merge in order to make better use of their collective resources and capabilities. As a matter of fact, if students are having difficulty identifying examples of industries with blurred boundaries, it might be easier to ask them to find examples of industries that share these common characteristics and then discuss whether or not the boundaries are blurring.

- Brainstorm possible advantages of strategic alliances for small and medium-sized firms. How might these advantages help defend against the five forces?

Ask the students to come up with some advantages of strategic alliances, such as the ability to pool resources and use them more effectively; the opportunity to gain access to new technology or other core competencies that one partner possesses and the other does not; the opportunity to learn from the strategic alliance partners; the ability to gain access to new customers that are served by the alliance partner; the opportunity to gain access to foreign markets and/or foreign suppliers, etc.

The use of strategic alliances can help smaller and medium-sized firms become more equal to larger competitors in terms of size and capabilities, thus minimizing the ability of those larger rivals to use price cuts or other measures to intensify rivalry and drive out the smaller firms. Alliance partners might also be able to erect barriers to entry as they join forces to create economies of scale, share proprietary technology, develop new ways to differentiate and capture favorable locations as well as access to raw materials/distribution channels. The airline code-sharing alliances are good ones to mention as examples, as they are partly an extension of the frequent flier or mileage programs, and also expand the reach of an airline such as American to places that it cannot secure routes (e.g. to East Asia, via its alliance with Hong Kong-based Cathay Pacific).

POSSIBLE ANSWERS TO CRITICAL DISCUSSION QUESTIONS

1. Why do price wars often erupt in certain industries, but less frequently in other industries? What can a firm do to discourage price wars or to better prepare for price wars?

   Price wars usually erupt when firms cannot easily differentiate their products from one another. As in the PC industry today, or along certain airline routes, price wars are common as most firms are not able to convince customers that their products are different from the competitors'. In addition, in a slow growing market, firms are more likely to compete for market share to emerge as one of the top two or three firms. To solve this problem, firms should not assume that their products are destined for commoditization; they may be able to add new features and functions to differentiate from lower end products. For example, Swatch was able to add fashion and a broader range of product offering to differentiate from the low-priced commodity watches that Swatch was (initially) targeted against. To better prepare for price wars, it is important to get costs down. This is not only cost cutting (which is a day by day process), but also doing other things consistent with a low cost strategy. This would include trimming the product line, minimizing product variation and customization, selling through distributors that can push the product, thus reducing promotion expenditure, and selling the products in quantity (bundling) whenever possible or feasible.

2. Compare and contrast the five forces affecting the airline industry, the fast food industry, the beauty products industry, and the pharmaceutical industry (1) on a *worldwide* basis and (2) in *your* country. Which industry holds more promise for earning higher returns? Why?

   It is useful to compare the US and Asian airline industries.
   <u>US Airlines</u>
   Entrants **--** *Moderate. There are a number of secondary airports in the US looking to expand and attract passenger jets to land. Easy to build a fleet by leasing planes.*
   Rivalry – High. This is a product that is still hard to differentiate. The frequent flier programs helped a little, but people joined multiple programs, so they are not a big edge anymore.
   Suppliers – Low. Sometimes the oil suppliers cause trouble for the airlines, but they do it to everyone, and usually only temporarily. The aircraft manufacturers are not that powerful; they compete fiercely for new business. Airline labor is very powerful in the US – they regularly bid away an airline's profit in new contracts, and have driven airlines to the brink of bankruptcy.
   Buyers – Moderate. Travel agents are a lot weaker today and passengers have a lot of choice and can

switch, but not on all routes.
Substitute products. Low to moderate. Some substitutes possible on short routes (less than 400 km), mostly on the US east coast and along the west coast. High-speed regional trains, though planned, will not be built in the near term.
Asian Airlines
Entrants – Moderate. Asia has many new airports and some secondary ones that are almost all under capacity. Analysts except significant competition, at least for holiday travelers in Southeast Asia, and increasingly in Greater China.
Rivalry – Low. Asian airlines still have markets carved up, with collaboration with their governments. Exceptions to this are coming from Southeast Asia, in Singapore-Jahal (Malaysia), and the Philippines.
Suppliers – Low. Labor is much weaker in Asia than in the US. Labor cannot bid away all an airline's profit in a labor contract or enact stifling work rules. Travel agents a bit more powerful, but heavy competition among agents in Asia. Similar supplier issues as in the US.
Buyers – Low. Not much choice for Asian travelers. They may be able to switch, but airlines dominant their regions (e.g. Cathay and Dragon Air in Hong Kong), so they have the most convenient flights and quantities of seats by far.
Substitute products. Low. Unless one has time to travel by ship around Asia, travelers are pretty much stuck with flying.
Contrast the Pharmaceutical industry*:*
Entrants – Low. Only a couple of significant entrants since the 1950s, mostly on the back of a new technology. This may change with the refinement of traditional (Chinese and Indian, primarily) complementary medicines. But not in the near-medium term.
Rivalry – Low. With the exception of the few drugs treating a well-known biological mechanism drugs rarely compete directly. Easy to differentiate.
Suppliers –Mostly low, though medical research staff is expensive.
Buyers – Low, but increasing. Individual patients are weak, physicians and hospitals not price sensitive. Governments are an emerging powerful buyer, however.
Substitutes – Low. Nothing has emerged as substitutes for most drugs (e.g. food products, other therapies). This may change with traditional Chinese and Indian medicine in the medium term.

3. Conduct a five forces analysis of the "business school" industry or the "higher education" industry. Identify the "strategic group" in which your home institution belongs to. Then use this analysis to explain why your home institution is doing well (or poorly) in the competition for better students, professors, donors, and ultimately rankings.

The students should follow the outline given in #2 above for the five forces with explanation and suggestions of changing patterns in the industry. For the strategic group of the university, ask the students to identify which universities (or business schools) compete most directly with their university, and which schools may be in the general vicinity, but are obviously not in the same market for students (e.g. technical schools, community colleges, small private schools, for example). Is the student's school able to differentiate from the competitors? Do people, particularly firms and recruiters, understand the school's mission and what it does best? Where does it excel, and what does it downplay or seek to not teach?

For example, in terms of strategic groups, the author's home institution, Ohio State University, *belongs to several such groups:*

- *Big Ten – Large, flagship, state universities in states in the Midwest (e.g., Indiana, Michigan, Minnesota, Purdue, etc)*
- *Self-defined national peer group (officially used by the university) – Big Ten + other schools "comparable in size and mission," which include Arizona State, Texas, UCLA, Washington, etc.*

- *Regional peer group – other schools in Central Ohio (e.g., Capital, Franklin, and Ohio Universities). For instance, Ohio State directly competes with them for students in the evening MBA program.*
- *State/public universities – This is the largest strategic group, based on ownership. One of the goals of Ohio State is become a leading public university.*

For most schools, it is possible to identify these different, yet somewhat overlapping, strategic groups. It is useful to assess how your school competes successfully (or unsuccessfully) against these different groups of competitors.

4. Among the eight debates outlined, choose the debate you feel most strongly about. Assemble the best evidence in support of your position and then be your own "devil's advocate" by assembling the best evidence to support the *opposing* position.

   Suggest that students look up these topics using the major business magazines such as Business Week, Fortune, The Economist, the Wall Street Journal, and perhaps one or two scholarly journals in that specialty. They should read at least 4 articles, hopefully two on both sides to formulate their arguments.

   Conclude with 1-2 paragraphs on how the articles help you understand and participate in the debate. For example, between two positions A and B, you had always intuitively supported A (before taking the class and doing this research). Now you find articles to intellectually support your support for A. Or, despite your initial belief in A, through this research, you find articles which refute your thinking and now you support B.

5. ON ETHICS: "Excessive profits" coming out of monopoly, duopoly, or any kind of strong market power are targets for government investigation and prosecution (for example, Microsoft was charged by both US and EU competition authorities). Yet, strategists openly pursue above-average profits, which are argued to be "fair profits." Do you see an ethical dilemma here? Make your case either as an antitrust official or as a firm strategist (such as Bill Gates).

   A good way to think about antitrust is that it is designed to preserve competition, not competitors. As long as there are viable alternatives to a product, and customers are not 'held up' by Microsoft or other very dominant players, then there is not dilemma or need for the government to intervene. Some felt that Microsoft was stopping innovation in the desktop computing market, back in the 1990s. There may have been some truth, legal or otherwise to that. But now, most analysts agree that Microsoft does not monopoly-price its products, and they put a great deal into research and development to improve the computing experience. In some ways, they are taking on the role of a utility, but one with at least some competition. "Fair profits" are difficult to define, it's probably best to stick to the legal definitions of predatory pricing, monopoly pricing, and illegal cross-subsidization and artificial product bundling, which are more objective in terms of anti-competitive, anti-consumer practices.

   A useful chapter to read is Chapter 8.

CLOSING CASE: *FIVE FORCES IN THE BEAUTY PRODUCTS INDUSTRY*

OVERVIEW

The beauty products industry encompasses make-up, skin, hair care, perfumes, cosmetic surgery, health clubs and diet pills, which is a $160 billion-a-year global industry. In the past few years, the industry has been growing at 7 percent annually, more than twice the rate of the developed world's GDP. This annual growth has bee fueled by a richer, aging baby boomers in developed countries and the increasingly affluent middle class in emerging economies, such as Brazil, China, India, Russia and South Korea.

Recently, there are three major changes that affect this beauty products industry. Though incumbent brands such as L'Oreal, Nivea, Shiseido, Elizabeth Arden and Max Factor still possess the remarkable staying power, the emergence of new entrants has intensified the competition. Both luxury goods producers and consumer products companies pose significant threats to those incumbents. Second, there is also a change in consumer behavior which consumers are now starting to buy products from discount retailers such as Wal-Mart. This change in consumer behavior has hurt smaller players, such as Estee Lauder and Revlon, which heavily depend on department stores instead. Finally, incumbents are increasingly fighting back through emphasizing the uniqueness of their products. For example, the new Body Creator skin gel of Shiseido, which claims to be able to melt 2.4 pounds of body fat a month without any need to diet or exercise, was bought in Japan every 3.75 seconds during the first year of the launch.

While the market for traditional beauty products becomes more competitive, substantial future growth of the industry might come from areas outside the main players: cosmetic surgery and well-being products. This is basically because of the changing nature of cosmetic surgery, which is no longer reserved for celebrities and actresses. The cost has dropped significantly, from $12,000 in earlier days to nowadays $600. This trend is particularly true in the US, where cosmetic surgery has become a $20 billion a year business and has grown by 220% since 1997. The other area of growth is well-being products, which include natural solutions such as spas, salons and clubs linking beauty with diet/exercise.

POSSIBLE ANSWERS TO CASE DISCUSSION QUESTIONS

1. Why do incumbents have long staying power in this industry?

Incumbents, such as L'Oreal, Nivea, Shiseido, Max Factor, and Elizabeth Arden have developed extremely strong brand images, which have helped them remain in business for more than 90 years. Each of these brands has been able to differentiate in ways that customers value and for which they are willing to pay. These incumbents have also been able to establish strong global distribution systems, effective research and development activities, and marketing capabilities – all of which serve as significant barriers to entry. As long as these brands continue to meet customer needs effectively and command brand loyalty, it will be difficult for substitute products to take away market share.

2. How do new entrants overcome entry barriers? How do incumbents react to new entrants?

Recently a number of firms from outside the traditional boundaries of the beauty products industry have entered through non-traditional distribution channels. New entrants, such as P&G and Unilever have experienced maturity in their core businesses, so they are pouring more resources into their beauty products divisions. In the past, incumbent brands were sold primarily through fashionable department stores. However, new competitors like Proctor and Gamble (P&G) and Unilever have been able to take away market share by developing a strong presence in discount retail chains, such as Wal-Mart. Since Wal-Mart prefers to deal with a small number of large suppliers, large companies like L'Oreal and P&G have a distinct advantage over their smaller counterparts, such as Estee Lauder and Revlon. In addition, *it is much less expensive for firms to sell through Wal-Mart and other no-frills retailers – the selling costs are much higher for fashionable department stores.*

A number of luxury goods producers, (e.g. Chanel, Dior, Ralph Lauren, Yves St. Laurent) have also entered the beauty products industry in recent years. These firms have established strong luxury brands and are attempting to overcome entry barriers by convincing customers that their brand loyalty should transfer over to branded beauty products as well. Both types of new entrants – consumer products firms and luxury goods producers – have strong marketing capabilities, research and development expertise, as well as global logistics systems, all of which will serve them well in their efforts to overcome entry barriers. Incumbent brands have responded to the threat of new entrants by trying to convince customers that their uniqueness is more valuable than the lower prices offered by new entrants. The case mentions that L'Oreal has been focusing its advertising on innovation, by calling attention to the number of patents that they have filed. Shiseido has also turned to marketing for help by making claims that their new Body Creator skin gel can melt fat without any need to diet or exercise.

3. Why do retail chains gain bargaining power as buyers at the expense of department stores?

Retail chains like Wal-Mart gain bargaining power as buyers because they purchase and then redistribute beauty products in such a huge volume. In addition, P&G, Unilever, and other consumer products companies depend on Wal-Mart and other discount retailers to distribute a large percentage of their annual sales. This dependence on retailers also gives them more bargaining power because without them sales revenues of the consumer products companies would decline sharply. In addition, P&G and Unilever want to sell their other products through this same retail channel, so the battle for shelf space in one product category might spill over into other product categories.

Department stores, on the other hand, do not purchase beauty products or consumer products in as high a volume as the discount retailers do. Consequently, the dependency relationship is not as strong and department stores do not wield as much bargaining power as large discount retailers.

4. Should traditional competitors focus on expanding new country markets in emerging economies or on entering hot, new growth product markets in developed economies?

One of the challenges traditional competitors in the beauty products industry face is making sure that their products add value and are affordable. Affordability is especially important if they choose to distribute their products in emerging economies. However, as mentioned in chapter one, consumers in emerging economies also prefer products that have been developed to meet their specific needs. Consequently, incumbents will need to make sure that if they enter emerging economies, they sell products with attributes that local customers desire and can pay for.

On the other hand, since incumbents are depending on the strength of their brands to help them win the battle over new entrants, it might make sense for them to enter some of the high growth markets in developing economies. Many of the incumbents already have brand images that are recognized and desired all around the world, so it might be possible for them to transfer that loyalty to complementary products in high growth markets. In either case, it is essential that incumbents develop products (and/or services) that add value for local customers.

Probably the ultimate answer to this question will depend on the best estimate as to the potential return on investment that will likely result from expansion in emerging versus developed economies.