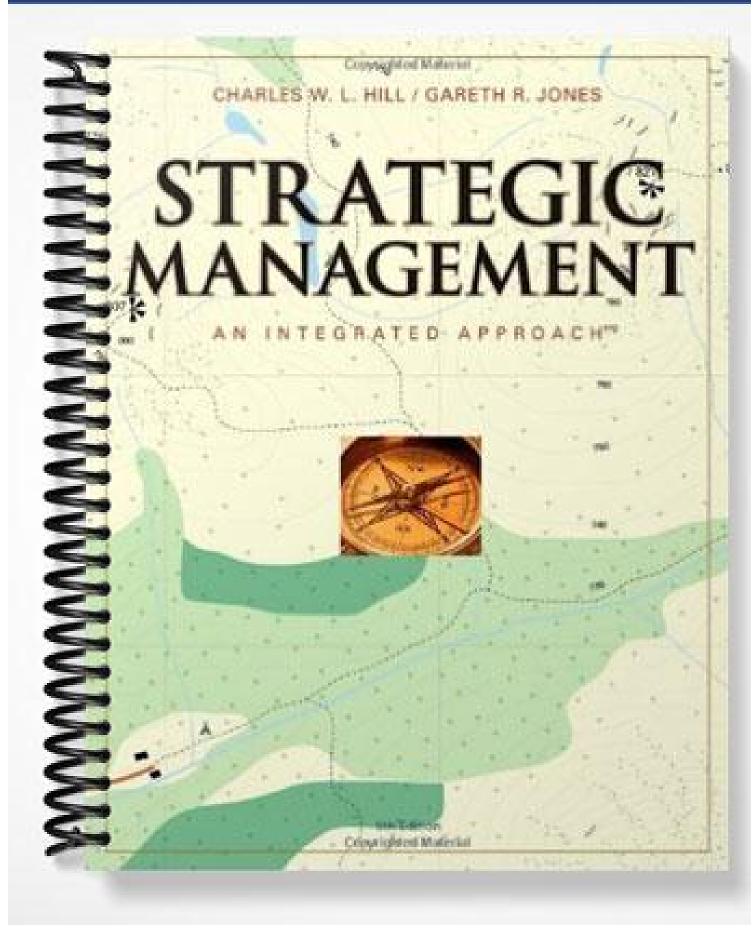
# SOLUTIONS MANUAL



CHAPTER 2

# Opportunities and Threats-Analzing the External Environment

## SYNOPSIS OF CHAPTER

The purpose of this chapter is to familiarize students with the forces that shape competition in a company's external environment and to discuss techniques for identifying strategic opportunities and threats. The central theme is that if a company is to survive and prosper, its management must understand the implications environmental forces have for strategic opportunities and threats.

This chapter first defines industry, sector, market segments, and changes in industry boundaries. The next section offers a detailed look at the forces that shape competition in a company's industry environment, using Porter's Five Forces Model as an overall framework. In addition, a sixth force—complementors—is introduced and discussed.

The chapter continues, exploring the concepts of strategic groups and mobility barriers. The competitive changes that take place during the evolution of an industry are examined.

Next the chapter considers some of the limitations inherent in the five forces, strategic group, and industry life cycle models. These limitations do not render the models useless, but managers need to be aware of them as they employ these models.

Finally, the chapter provides a review of the significance that changes in the macroenvironment have for strategic opportunities and threats.

## TEACHING OBJECTIVES

1. Discuss the main technique used to analyze competition in an industry environment-the five forces model
2. Describe the concept of strategic groups and illustrate its implications for industry analysis
3. Discuss how industries evolve over time, with reference to the industry life cycle model
4. Show how trends in the macroenvironment can shape the nature of competition in an industry

## OPENING CASE

### *THE UNITED STATES STEEL INDUSTRY*

The U.S. steel industry has been met with numerous problems for the last few decades. Factors contributing to its demise were falling trade barriers, competition, decreasing demand, excess capacity, and unionization. With bankruptcies and consolidation, restructured enterprises were now faced with productive workforces and new technology. With a decline in the value of the U.S. dollar after 2001, more steel exports were created resulting in competitive pricing and higher profits. With many countries spending for infrastructure rebuilding to stimulate their economies, demand for steel surged and allowed for price increases and profitability for U.S. steelmakers, even in the face of a U.S. recession.

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**Teaching Note:**

This case introduces many of the themes of Chapter 2, including the impact that competitive forces have on industry behavior and profitability, concepts about market segmentation and strategic groups, and the changing nature of competition over an industry's life cycle. One of the most important lessons of this chapter and this case, and one that may be somewhat surprising to students, is the very strong influence that external environments can have on firm performance. Much of what is discussed in the popular business literature focuses on the achievements or shortcomings of individual managers and other forces internal to the firm. But it is worthwhile to remind students that external forces can have just as much impact and can even cause the demise of industries with competent managers.

## LECTURE OUTLINE

I. Overview
  A. For a company to succeed, its strategy must either fit the industry environment in which it operates, or the company must be able to reshape the industry environment in which it operates to its advantage through its choice of strategy. Companies typically fail when their strategy no longer fits the environment in which they operate.
  B. To achieve a good fit, managers must understand the forces that shape competition in their external environment. This understanding enables them to identify strategic opportunities and threats. **Opportunities** arise when a company can take advantage of conditions in its environment to formulate and implement strategies that enable it to become more profitable. **Threats** arise when conditions in the external environment endanger the integrity and profitability of the company's business.

II. Defining an Industry
  A. An **industry** can be defined as a group of companies offering products or services that are close substitutes for each other. Close substitutes are products or services that satisfy the same basic consumer need. Firms within the same industry are rivals, also called **competitors**.
    1. A correct industry definition can be the difference between success and failure.
    2. Managers must define industries based on the customer need (the demand side of the market) and *not* the products the industry offers (the supply side of the market).
  B. Several industries combine to create a **sector**. For example, the PC industry, the handheld industry, and the mainframe industry together create the computer sector.

***Figure 2.1: The Computer Sector: Industries and Segments***

  C. Within industries, customers with a common need group together to form a **market segment**. For example, the soft drink industry contains regular, diet, and caffeine-free market segments.
  D. Industry boundaries are not fixed, but can change over time. Industries may fragment into a set of smaller industries, such as when the auto industry fragmented into the car and SUV industries. Industries may also consolidate, such as the blurring of the boundary between the handheld computer and cell phone industries.

III. Porter's Five Forces Model
  A. This model was devised by Michael Porter to describe forces that shape competition within an industry and help to identify strategic opportunities and threats. The stronger each of these forces is the more established companies are limited in their ability to raise prices and earn greater profits. A strong competitive force is a threat because it depresses profits. A weak competitive force is an opportunity because it allows the company to earn greater returns.

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***Figure 2.2: Porter's Five Forces Model***

B. One of Porter's five forces is the risk of entry by potential competitors. **Potential competitors** are companies that are currently not competing in the industry but have the capability to do so. New entry into an industry expands supply. This in turn depresses prices and profits. Thus a high risk of new entry constitutes a strategic threat. A low risk of new entry allows established companies to raise their prices, therefore it constitutes an opportunity. The risk of entry by potential competitors is a function of the height of **barriers to entry**. The height of barriers to entry is determined by several factors.

1. **Economies of scale** arise when unit costs fall as a firm expands its output. Sources of economies include 1) cost reduction gained through mass-producing a standardized output; 2) discounts on bulk purchases of raw material inputs and component parts; 3) the advantages gained by spreading fixed production costs over a large production volume; and 4) the cost savings associated with spreading marketing and advertising costs over a large volume of output.
2. The extent to which established companies have **brand loyalty** from their customers is one factor. Loyal customers would discourage potential competitors.
3. Potential competitors are also discouraged when established companies enjoy an **absolute cost advantage** over potential entrants. Cost advantages might include factors such as patents, control of a specific raw material, or access to cheaper funds.
4. When customer **switching costs**—that is, costs that accrue to a consumer that intends to switch from the product offering of an established company to the product offering of a new entrant—are high, potential new entrants are discouraged.
5. **Government regulations**, such as establishing a protected monopoly, tend to protect established firms, and thus constitutes a barrier to entry. When industries are deregulated new entrants usually proliferate.

**Strategy in Action 2.1 Circumventing Entry Barriers into the Soft Drink Industry**

The soft drink industry has long been dominated by two companies, Coca-Cola and PepsiCo. Both companies have historically spent large sums of money on advertising and promotion, which has created significant brand loyalty and made it very difficult for prospective new competitors to enter the industry and take market share away from these two giants. When new competitors do try and enter, both companies have shown themselves capable of responding by cutting prices, forcing the new entrant to curtail expansion plans.

However, in the early 1990s the Cott Corporation, then a small Canadian bottling company, worked out a strategy for entering the soft drink market. The company used a deal with RC Cola to enter the cola segment of the soft drink market. Cott next introduced a private label brand for a Canadian retailer. Both of these offerings took share from Coke and Pepsi. Cott then decided to try and convince other retailers to carry private label cola. Cott spent almost nothing on advertising and promotion. These cost savings were passed onto retailers in the form of lower prices. For their part, the retailers found that they could significantly undercut the price of Coke and Pepsi colas, and still make better profit margins on private label brands than on branded colas.

Despite the savings, many retailers were leery of offending Coke and Pepsi and declined to offer a private label. Cott was able to establish a relationship with Walmart as it was entering the grocery market. The "President's Label" became very popular. Cott soon added other flavors to its offering, such as a lemon lime soda that would compete with Seven Up and Sprite. Moreover, pressured by

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Walmart, by the late 1990s other U.S. grocers also started to introduce private label sodas, often turning to Cott to supply their needs.

By 2006, Cott had grown to become a $1.8 billion company. Its volume growth between 2001 and 2006 in an otherwise stagnant U.S. market for sodas was roughly 12.5%. The largest private label company, Cott captured over 5% of the U.S. soda market in 2005, up from almost nothing a decade earlier. The losers in this process were Coca-Cola and Pepsi Cola, who were now facing the steady erosion of their brand loyalty and market share as consumers increasingly came to recognize the high quality and low price of private label sodas.

**Teaching Note:**

As this case illustrates, entry barriers can be effective in discouraging new entrants; however, they can be circumvented. Cott was able to enter a much closed industry through a combination of its own efforts and the changes brought to the industry environment by the advent of Walmart. You can use this case in a classroom discussion to identify entry barriers in other industries. Another approach to classroom discussion is to ask students to consider the lessons that other industries might learn from Cott. What did the Cott do to lower entry barriers, and how could those tactics be used in another context?

C. Another of Porter's five forces is **rivalry** among established companies. Strong rivalry tends to lower prices and raise costs, which constitutes a threat to established companies, whereas weak rivalry creates an opportunity to earn greater returns. The extent of rivalry among established firms depends on several factors.

1. One factor is industry competitive structure, which refers to the number and size distribution of companies within an industry. Structures vary from fragmented (made up of many small- and medium-sized companies) to consolidated (dominated by a small number of large companies). Different competitive structures have different implications for rivalry.
    a) Many fragmented industries are characterized by low entry barriers and commodity-type-products that are hard to differentiate. These characteristics tend to result in boom-and-bust cycles, with a flood of new entrants, excess capacity, and price wars, leading to low industry profits and exit from the industry. The more commodity-like an industry's product, the more vicious the price war. The "bust" part of the cycle will continue until overall industry capacity is brought into line with demand (through bankruptcies), at which point prices may stabilize again.
    b) Consolidated industries are interdependent, so that the competitive actions of one company directly affect the profitability of competitors, forcing a response from them. The consequence can be price wars like those the airline industry has experienced. Thus interdependence is a major threat. This threat can be reduced when tacit price-leadership agreements exist within the industry and when companies are successful in emphasizing nonprice competition.

2. Demand conditions also determine the intensity of rivalry among established companies. Growing demand moderates competition by providing room for expansion. Declining demand results in more competition as companies fight to maintain revenues and market share.
3. Cost conditions are another determinant of rivalry between firms. High fixed costs lead to a focus on volume of sales in order to cover these costs. This focus on volume can

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spark intense rivalry if demand is weakening and too many firms are involved in providing the same products. This situation will prompt firms in the industry to lower prices in order to capture sufficient sales to cover costs.

**Strategy in Action 2.2 Price Wars in the Breakfast Cereal Industry**

The breakfast cereal industry in the U.S. was one of the most profitable and desirable competitive environments, with steadily rising demand, brand loyalty, and close relationships with buyers (grocery retailers). Best of all, the industry was dominated by just three competitors, and one, Kellogg's, controlled 40% of the market share. Kellogg's was a price leader, raising prices a bit each year, and the smaller companies followed suit. Then the industry structure changed. Huge discounters began to promote cheaper private brands, just as bagels or muffins replaced cereal as the preferred breakfast food. Under pressure, the big manufacturers began a price war, ending the tacit price collusion that had kept the industry stable and profitable. Although profit margins were slashed in half, the big three continued to lose market share to private brands. What was once a desirable industry is now exactly like most others—competitive, unstable, and far less profitable.

**Teaching Note:**

This case illustrates the sad outcomes that result when industry competitors react to increased pressure by breaking off tacit price collusion. You should be sure to emphasize to students the difference between *tacit price collusion*, which is indirect and therefore legal, and *price fixing*, which is overt and therefore illegal. Again, the message here is that a well-run industry, with sustained high profitability and stability for all competitors, fell victim to powerful external forces. An interesting discussion question would be to ask students, "Is there any action the big three competitors can take now to undo the damage and recover their profitability?" If students suggest any action that they believe will restore the situation, ask them how the other competitors would be likely to react. For example, if students suggest a one-sided price increase, ask them if competitors would be likely to follow suit. Students may be surprised to realize how difficult it is to "put the genie back in the bottle"; once trust is destroyed, an industry may never be able to recreate stability and prosperity.

4. Exit barriers are a serious competitive threat, especially when demand is declining. Economic, strategic, and emotional factors can keep companies competing in an industry even when returns are low. This in turn leads to excess capacity and price wars. Exit barriers include:
    a) investments in specialized assets
    b) high fixed costs of exit such as severance pay
    c) emotional attachments to an industry
    d) economic dependence on a single industry
    e) the need to maintain expensive assets in order to compete effectively in that industry.

D. A third factor in Porter's five forces model is **the bargaining power of buyers**. Buyers can be individual consumers, other businesses, wholesalers, or retailers. Buyers can be viewed as a competitive threat when they force down prices or when they raise expenses by demanding higher quality and better service. The ability of buyers to make demands on a company depend on their power relative to that of the company. Buyers tend to be powerful when:

1. they are in industries that are more highly consolidated than the company's industry
2. they purchase in large quantities or constitute a significant buyer for that industry

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3. supply industry depends on the buyers for a large percentage of its total orders.
4. buyers can easily switch to a substitute product or an alternate supplier
5. when it is feasible for buyers to purchase an input from several companies at once
6. buyers can readily produce the product themselves

**Running Case Walmart's Bargaining Power over Suppliers**

When Walmart and other discounter retailers got their start in the 1960s, they were small operations with little purchasing power. They depended on nationally branded merchandise to generate store traffic but were price takers and received few discounts from the manufacturers. They cut costs by emphasizing self-service stores in suburban locations. Discounters such as Kmart purchased their merchandise through wholesalers, who in turn bought from manufacturers. This option wasn't acceptable to Walmart due to its rural locations and the high fees wholesalers expected. Instead Walmart went public and used the capital to build a distribution center to stock merchandise for stores within a 300-mile radius. Because the distribution center was buying for a number of stores it was able to buy in larger volumes directly from the manufacturers. The cost savings were passed on to consumers in the form of lower prices. Walmart continued to grow, increasing its buying power and developing the ability to demand greater discounts from manufacturers.

Today 8% of all retail sales in the United States are made in a Walmart store, so the company has enormous bargaining power over its suppliers. People don't go to Walmart to buy branded goods; they go to Walmart for the low prices. This simple fact has enabled Walmart to bargain down the prices it pays, always passing on cost savings to consumers in the form of lower prices.

**Teaching Note:**

The case discusses how Walmart's buying power has changed over the years as the company has become larger. You can ask students to describe how Walmart's buying power has increased over time and discuss how the actions reinforce one another.

E. A fourth factor is **the bargaining power of suppliers.** Suppliers are any organization that supplies materials, services, or labor (such as labor unions) to the company. Suppliers are a threat when they are able to force up the price the company must pay for inputs or to reduce the quality of goods supplied. The ability of suppliers to make demands on a company depends on their power relative to that of the company. Suppliers tend to be powerful when:
   1. the supplier's product has no substitutes or is vital to the company
   2. the company is not important to the supplier
   3. the company has a switching cost to change suppliers
   4. suppliers can readily enter the company's industry
   5. the company cannot readily enter the supplier's industry

F. A fifth factor is the threat of **substitute products**. The existence of adequate substitute products limit the price that companies in an industry can charge without losing their customers to makers of substitutes. The threat of substitutes tends to be greater when:
   1. the substitute is a close one, equally adequate in filling customers' needs
   2. the price of the substitute is equal to or less than the company's products

G. Recently, Intel CEO Andy Grove proposed a sixth force: **complementors**, or companies that sell products that are used in addition to and along with the enterprise's own products. When there is a weak supply of complementary products, demand in the industry will be weak, and

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revenues and profits will be low. The threat from a lack of complementors tends to be greater when:

1. few complementary products exist
2. the existing complementary products are not attractive to customers, due to high prices, inadequate features, and so on

**Teaching Note: Ethical Dilemma**

While discussion could enter into whether or not moral objections should influence analysis and recommendations, the real question should focus on whether or not casinos will be a complement to the industry. Will casinos bring value to the customers? Will casinos generate demand for the hotel industry?

IV. Strategic Groups Within Industries

A. A **strategic group** is a group of companies within an industry that are pursuing the same basic strategy as the companies within the group but different strategies than those of companies outside the group. The strategies may be based on a variety of factors, such as differences in quality, market segment served, or distribution channel utilized. Normally, a limited number of strategic groups capture the essence of strategic differences among companies within an industry.

***Figure 2.3: Strategic Groups in the Pharmaceutical Industry***

B. Strategic groups have several implications for internal analysis.

1. A company's immediate competitors are those in its strategic group. Because all companies in a strategic group are pursuing similar strategies consumers tend to view the products of such enterprises as direct substitutes for each other.
2. Different strategic groups can have a different standing with respect to the threats and opportunities they face from each of Porter's five competitive forces. Some strategic groups are more desirable than others, characterized by a lower level of threats and/or by greater opportunities.
3. **Mobility barriers** are factors that inhibit movement between groups. They are analogous to industry entry barriers and are based on the same factors: brand loyalty, absolute cost advantages, and economies of scale. Mobility barriers make it difficult for companies to move into another strategic group. They also protect group members from entry by companies from other groups.

V. **Industry Life Cycle** Analysis

A. Over time, industries pass through a series of well-defined stages with different implications for the nature of competition. Porter's five competitive forces and competitive dynamics change as an industry evolves. Managers must learn to anticipate the changes that will occur as the industry develops over time.

***Figure 2.4: Stages in the Industry Life Cycle***

B. An **embryonic industry** is one that is just beginning to develop. Growth is slow because of buyer unfamiliarity with the industry's products, poor distribution channels, and high prices stemming from the inability of companies to reap economies of scale.

1. Barriers to entry at this stage tend to be based on access to key technological know-how, rather than cost economies or brand loyalty. Rivalry in embryonic industries is based on educating customers, opening up distribution channels, and perfecting the design of the product.

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2. Embryonic industries provide a good opportunity for firms to capture loyal customers, capitalizing on the lack of rivalry.

C. A **growth industry** is one where first-time demand is expanding rapidly as new consumers enter the marketplace. Typically, demand takes off when consumers become familiar with the product, prices fall with the attainment of economies of scale, and distribution channels develop.

1. During an industry's growth stage, there tends to be little rivalry. Rapid growth in demand enables companies to expand their revenues and profits without taking market share away from competitors.
2. Growth industries provide opportunities for firms to expand their market share and revenues in a relatively low rivalry situation. Firms entering at this stage avoid the high expenses of initial product development.

D. An **industry shakeout** occurs when the rate of industry growth slows down as demand approaches saturation levels. A saturated market is one where there are few first-time buyers left. Most of the demand is limited to replacement demand.

1. As an industry enters the shakeout stage, rivalry between companies becomes intense, with excess productive capacity and severe price discounting. Many firms exit the industry at this point.
2. Industry shakeout provides an opportunity for those firms that are dedicated to success in this particular industry to consolidate their power, often by acquiring the assets of firms exiting the industry.

***Figure 2.5: Growth in Demand and Capacity***

E. A **mature industry** is one where the market is totally saturated, growth is very low or near zero, and demand is limited to replacement demand. Most competitors have exited the industry, creating an oligopoly dominated by a few large companies.

1. As an industry enters maturity, barriers to entry increase and the threat of entry from potential competitors decreases. Intense competition for market share can develop, driving down prices.
2. In mature industries, companies tend to recognize their interdependence and try to avoid price wars if possible. Stable demand gives them the opportunity to enter into price-leadership agreements, reducing the intensity of rivalry and allowing greater profitability. However, the stability of a mature industry is always threatened by further price wars, especially in an economic downturn.

F. In the **decline stage,** growth becomes negative. Virtually all companies exit the industry.

1. Depending on the speed of the decline and the height of exit barriers, competitive pressures can become as fierce as in the shakeout stage.
2. Falling demand leads to excess capacity, causing companies to engage in price wars. The greater the exit barriers, the harder it is for companies to reduce capacity and the greater is the threat of severe price competition.

VI. Limitations of Models for Industry Analysis

A. The five forces, strategic groups, and industry life cycle models constitute very useful ways of thinking about and analyzing the nature of competition within an industry. However, these models have limitations. It does not mean the models are useless. It does mean, however, that managers must be aware of the limitations as they apply these models to their firms.

B. One important limitation of the life cycle model is that industry life cycles vary considerably, skipping or repeating stages, moving slowly or rapidly through the stages, or remaining "stuck" at a particular stage.

C. Another limitation of all of these models is the lack of attention paid to the consequences of innovation. Over time, innovation in many industries leads to new products, processes, or

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strategies that can be very successful and transform the nature of competition within an industry. Innovation can fragment or consolidate an industry, create new strategic groups or market segments, speed or slow an industry's life cycle, and otherwise disrupt the orderly predictions of all three of the models for industry analysis.

1. Michael Porter, the originator of the five forces model, has recently shifted focus to acknowledge the role of innovations as "unfreezing" and "reshaping" industry structure. Porter describes a model of punctuated equilibrium, in which an innovation triggers a period of turbulence, followed by a period of stability. The punctuated equilibrium theory allows Porter's five forces model to continue to be somewhat useful, in spite of limitation. This theory asserts that the five forces model is not a good predictor of the changes that take place in the short time just after an important innovation, but it is useful in the longer periods of stability that follow the turbulence.

***Figure 2.6: Punctuated Equilibrium and Competitive Structure***

2. However, there are those who question the validity of the punctuated equilibrium approach. Dr. Richard D'Aveni has argued that many industries are **hypercompetitive**, and are characterized by permanent and ongoing innovation. In hypercompetitive industries, industry structure is constantly being revolutionized by innovation; there are no periods of equilibrium. Thus, the three models of internal analysis are not useful.

D. Another limitation of the models for internal analysis is the lack of attention paid to firm-specific factors. Studies point to enormous variance in the profit rates of individual companies within an industry, with industry effects accounting for only 10 to 20% of the variance. These studies suggest that the individual resources and capabilities of a company are far more important determinants of that company's profitability than the industry or the strategic group of which the company is a member.

VII. The Macroenvironment

A. The **macroenvironment** refers to the broader economic, technological, demographic, social, and political environment within which an industry is embedded. It is apparent that changes in this macroenvironment can have a direct impact on any one of the five forces in Porter's model, thereby altering the relative strength of these forces and, with it, the attractiveness of an industry.

B. There are five important forces in the macroenvironment.

***Figure 2.7: The Role of the Macroenvironment***

1. **Macroeconomic forces** include changes in the growth rate of the economy, interest rates, currency exchange rates, and inflation rates; these are all major determinants of the overall level of demand. Adverse changes in any of these can threaten profitability in an industry, whereas positive changes tend to increase profitability.
2. **Global forces** include globalization of production and markets. Industry boundaries no longer stop at national borders and competitors can come from other national markets, increasing rivalry. Globalization can also provide opportunities for new markets for national firms.
3. **Technological forces** are characterized by an accelerated pace of innovation and change. Technological change can make established products obsolete overnight, but at the same time, it can create new products and processes. Thus technological change is both an opportunity and a threat; it is creative and destructive.
4. **Demographic forces** consist of any trends related to population, such as the aging of the U.S. population and the movement of people across national boundaries. Changing

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demographics create both opportunities and threats, spawning new industries and products while eliminating others.

5. **Social forces** consist of changes in societal preferences and values. New social movements also create opportunities and threats. For example, the impact of the trend toward greater health consciousness has been a boon to the fitness equipment and organic foods industries, while it has hurt the beef and cigarette industries.
6. **Political and legal forces** are shaped by changing laws and regulations. Factors such as deregulation, insurance reform, and even the political party makeup of Congress can create opportunities and threats for companies in many industries.

## ANSWERS TO DISCUSSION QUESTIONS

1. Identify a growth industry, a mature industry, and a declining industry. For each industry, identify the following: (a) the number and size distribution of companies; (b) the nature of barriers to entry; (c) the height of barriers to entry; and (d) the extent of product differentiation. What do these factors tell you about the nature of competition in each industry? What are the implications for the company in terms of opportunities and threats?

   Students' answers will vary depending on the companies they select. For example, growth industries might include the personal computer industry, the computer software industry, and the nursing home industry. Mature industries include the auto industry, the airline industry, and the beer industry. Declining industries include the tobacco industry, the sugar industry, and the steel industry.

   Growth industries tend to have many firms and be relatively fragmented. Barriers to entry may center on access to technological know-how, but overall, are low. Product differentiation also tends to be relatively low. Mature and declining industries have fewer firms and are more consolidated than growth industries. In addition, they have much higher barriers to entry, in the form of cost economies and brand loyalties. Product differentiation in mature and declining industries becomes much greater as an industry approaches maturity.

   These changes reveal that the nature of competition in an industry also changes as the industry moves from growth through maturity and into decline. Specifically, a growth industry is characterized by relatively benign competitive pressures. Mature industries are characterized by an emphasis on nonprice competition as a means of avoiding damaging price wars, although price wars may break out from time to time. Competition in a declining industry depends on the speed of decline and the height of exit barriers. The faster the decline and the higher the exit barriers, the more intense is the competition within a declining industry.

   In summary, the availability of opportunities decreases and the intensity of competitive threats increases as an industry passes from growth through maturity and into decline.

2. Under what environmental conditions are price wars most likely to occur in an industry? What are the implications of price wars for a company? How should a company try to deal with the threat of a price war?

   Price wars are most likely to occur when the following conditions are present in an industry: the product is a commodity, exit barriers are substantial, excess capacity exists, the industry is consolidated, and demand is declining. A price war constitutes a strong threat. It is difficult for companies that market commodity-type products to build brand loyalty; therefore, competition tends to focus on price. High exit barriers make it hard for companies to eliminate excess capacity through plant closings. In turn, the persistence of excess capacity leads to price cuts, as companies strive to generate enough demand to utilize their ideal capacity and cover fixed costs. In a

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consolidated industry, interdependence implies that one company's price cuts will elicit a response from its rivals, producing a downward spiral of prices. And it is declining demand that produces excess capacity and sparks off a price war in the first place. If all these conditions are present a severe price war is likely.

Survival depends on a company's ability to reduce operating costs and build brand loyalty so that it can retain its customers and still make profits when those of its competitors have dried up. Furthermore, the risk of a damaging price war can be reduced if the company can successfully enter into tacit price agreements with its competitors and if it can stress nonprice factors when competing. As demand declines, however, tacit price agreements can be difficult to maintain. Finally, if excess capacity is the major reason for a price war, capacity reduction agreements between competitors, or mergers between competitors followed by the elimination of excess capacity, may be suitable strategies for attacking this problem.

3. Discuss Porter's five forces model with reference to what you know about the steel industry. (see the Opening case). What does the model tell you about the level of competition in this industry?

*Potential competitors:* Recent high profitability and an enormous surge in demand for steel worldwide, there may be room for new entrants. Barriers to entry include the high cost of plant and equipment, raw materials and labor, and the uncertainty of economic stability, the strength of the U.S. dollar, and governmental regulation. There are numerous and emerging substitutes such as aluminum, plastics, and composites. Economies of scale are available to the only the largest producers.

*Rivalry among established companies:* Rivalry between the existing mass market steel industry producers is intense; however, investment in infrastructure by developing countries, notably China, has driven demand to the point where price and profitability have shown strength.

*Bargaining power of buyers:* Consumers have little power in the steel industry. However, when substitutes are available they are able bargain down prices as was done historically in the industry.

*Bargaining power of suppliers:* Steel industry suppliers deal mostly in commodities and therefore, have little power in the industry. Suppliers are also threatened by potential and existing substitutes.

*Threat of substitute products:* Substitutes for the steel industry include aluminum, plastics, and composites. Also, a trend toward environmentally-conscious substitutes may affect this industry and the demand for steel in the future.

In sum, the five forces model suggests that the overall intensity of competition in the steel industry would remain tight while leaving little opportunity for profitable new entrants. While the steel industry appears profitable in an economic downturn, it appears to be driven mainly by governmental agendas regarding infrastructure rebuilding.

## CLOSING CASE

### *THE UNITED STATES BEER INDUSTRY*

The United States beer industry is characterized by an increase in the concentration of the market. With U.S. beer production being provided by just three companies, the mass market segment of the industry revolves around competitive pricing, brand loyalties, distribution channels, and national advertising spending. The industry tends to be dominated by large established enterprises that have the scale required to bear the considerable costs and risks associated with developing new products and, moreover, can afford to spend large amounts of money to promote those products in the marketplace.

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There are opportunities for these firms in terms of new wines and spirits as well as threats from premium beer brewers.

**Teaching Note:**

This case introduces many of the themes of Chapter 2, including the impact that competitive forces have on industry behavior and profitability, concepts about market segmentation and strategic groups, and the changing nature of competition over an industry's life cycle. One of the most important lessons of this chapter and this case, and one that may be somewhat surprising to students, is the very strong influence that external environments can have on firm performance. Much of what is discussed in the popular business literature focuses on the achievements or shortcomings of individual managers and other forces internal to the firm. But it is worthwhile to remind students that external forces can have just as much impact and can even cause the demise of firms with competent managers.

## ANSWERS TO CASE DISCUSSION QUESTIONS

1. Why has the United States brewing industry become more concentrated over the last two decades?

   The concentrated market is due to consolidation (acquisitions and mergers, primarily), mass marketing techniques including increased national advertising budgets, aggressive pricing, and emphasis on development of brand loyalty.

2. Analyze the competitive structure of the industry using Porter's competitive forces model.

   *Risk of Entry*: The industry tends to be dominated by large established enterprises that have the scale required to bear the considerable costs and risks associated with developing new beers and, moreover, can afford to spend large amounts of money to promote those beverages in the marketplace. New entrants face a steadily increasing minimum efficient scale of production, meaning that more and more product is required to achieve any economies of scale.

   *Rivalry among established companies:* Rivalry is high evidenced by the small number of competitors, aggressive price competition, and intense brand competition. The top two or three firms account for 80% of the industry sales. When one company introduces a new product, service, or program, the others are forced to respond. Demand conditions are weakening due to increased sales of premium beers, wine, and spirits, and cost conditions remain high. This further intensifies rivalry as costs go up and profits narrow.

   *Bargaining power of buyers:* Where large corporations and distributors can force price concessions, this can be considered a threat in the beer industry. Consumers themselves have a high level of bargaining power as they can be particularly price-sensitive without intense brand loyalty.

   *Bargaining power of suppliers:* Most raw materials in the beer-making process are commodities so there is little bargaining power of suppliers in this industry.

   *Substitutes:* Many substitutes are in existence for mass-market beer, such as micro-brewed beer, wine, and spirits.

   The cumulative effect of these five forces is that the mass-market beer industry can be considered an oligopoly or a dominated profitable industry in its mature stage. The stability of a mature industry like this is always threatened by further price wars.

3. What are the implications of the evolving competitive structure in the brewing industry for the profitability and strategy of a smaller mass market firm in the industry?

   The premium beer segment is an opportunity for the smaller firm but once it is imitated by a powerful established company such as Anheuser Busch, they only, at present, have the resources to accelerate such placement in the market.

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4. Are there different strategic groups in the industry? What are they?

   Proprietary groups include the mass market segment served by Anheuser Busch and SAB-Miller Molson Coors, and the premium beer segment served by micro breweries and importers.

   Do you think the nature of competition varies among groups?

   The nature of competition will vary widely as the former is a mature industry and the latter a growth industry. The number of competitors is much greater in the premium beer segment and rivalry is lower. Product differentiation is high and demand conditions are favorable as each brewery markets to an exclusive, discerning buyer group. Price competition is not as intense and the use of targeted marketing strategies is more prevalent.

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