2. STRUCTURAL ANALYSIS OF INDUSTRIES

The essence of formulating competitive strategy is relating a company to its environment. A useful way gaining insight into the competitive environment is through industry analysis. As a working definition, an industry can be defined as a group of firms that produce products that are also substitutes for each other.

In any industry, competition works to drive down the rate of return on invested capital [or some called return on capital employed (ROCE)] as compared to the rate that would be earned in the economist's "perfectly competitive" industry. Increases in capital inflow either from new entrants or from additional investment by existing competitors is expected. Therefore, knowledge of these underlying sources of competitive pressure certainly helps in the identification of strengths and weaknesses of the company and allowing it to position itself strategically in its industry. Besides that, it also help in identifying areas where strategic changes may yield the greatest pay-off and establish strong foothold in tapping the opportunities while maintaining the company's ability to counter the threats with its strengths.

The five competitive forces :- 1) Entry, 2) Threat Of Substitution, 3) Bargaining Power Of Buyers, 4) Bargaining Power Of Suppliers and 5) Rivalry among current competitors - reflect the fact that competition in an industry goes well beyond the established combatants in a particular industry. All five competitive forces jointly determine the intensity of industry competition and profitability, identifying the strongest force or forces that are crucial from the point of view of strategy formulation. The collective strength of these force determines the ultimate profit potential of an industry. It ranges from "intense" in industries like computers, tyres and certain consumer goods where no company earns spectacular returns on investment, to "mild" in industries like oil field services and equipments, consultancy services, toiletries where there is room for quite high return.

Different forces assume different prominence in shaping competition in each industry. For example, in the ocean going tanker industry the key force is probably the buyers (the major oil companies), while in tyres industry, it is the powerful OEM buyers coupled with tough competitors. Every industry has an underlying structure, or a set of fundamental economic and technical characteristics that give rise to these competitive forces. The CEO of each competing company, in search for realization of its mission and vision, must learn what makes the industry environment tick. The competing companies not only wanting to cope well with its industry environment but also aspired to influence that environment in favor of its own.

In short, the focus of "Structural Analysis" is on identifying the basic underlying characteristics an industry rooted in its economics and technology that shape the arena in which competitive strategy must be set.

We will now discuss the five forces in greater details;

1) **THREAT OF ENTRY**

Threat of entry will depend on the extent to which there are barriers to entry coupled with the reaction from existing competitors that the entrant can expect. New entrants as we know, can cause "turbulence" in the industry by bringing in new capacity , changes trends , and often substantial resources. The typical sources of barriers to entry are as follows :-

Economies Of Scale. This refers to declines in unit costs of product when the production volume increases. Economies of scale deter entry by forcing the entrants to come in at large scale and risk strong reaction from existing firms on come in small scale and accept a cost disadvantages, both undesirable options. Units of multi-business firm may be able to reap economies to those of scale if they are able to share operations or functions subject to economies of scale with other businesses in the company. The benefits of sharing are particularly potent if there are "Joints-costs". Joint-costs occur when a firm producing product A must inherently have the capacity to produce product B e.g. air passenger services and air cargo , the firm that competes in both passenger and freight may have a substantial costs advantage over the firm competing in only one market. Other situation of joint costs occurs is when business units can share intangible assets such as brand names and know-how.

Product Differentiation. By differentiation is meant the provision of a product or service regarded by user as meaningfully different from the competition. It may have brand identification and customer loyalties , which stem from past advertising , customer service , product differences or simply being first into the industry. Organizations able to achieve differentiation provide for themselves real barriers to competitive entry.

Access To Distribution Channels. A barrier of entry can be created by the new entrant's need to secure distribution for its products for decades, the UK brewing companies, like many of their German and French counterparts, invested in the ownership or financing of pubs, which guaranteed the distribution of their products and excluded competitive products. This made it difficult for competitors to break into the market. However, this was undone in the late 1980s to allow a free entry of competitor products. The more limited the wholesale or retail channels for a products are and the more existing competitors have these tied-up, obviously, the tougher entry into the industry will be.

The Capital Requirement Of Entry. The need to invest large financial resources in order to compete creates a barrier to entry, particularly if the capital is required for risky on unrecoverable up-front advertising or research and development (R & D). Capital may be necessary not only for production facilities but also for things like customer credit, inventories or covering start-up losses the capital cost of entering a market will vary according to technology and scale. For example, the cost of setting up a retail clothing business with leased premises and stock from wholesalers is minimal when compared to the cost of say, entering capital intensive industries such as chemicals and heavy machineries.

Cost Advantages Independent Of Size. Established firms may have costs advantages not replicable or not easily matched by potential entrants no matter what their size and attained economies of scale. To a large extent, these are to do with early entries into the market and the experience so gained. It is difficult for a competitor to break into a market if there is an established operator who knows that market. Well, has possess the proprietary product technology, has good relationships with the key buyers and suppliers, located at favorable locations, gained preferential government subsidies and knows how to overcome market and operating problems.

Switching Costs. A barrier to entry is created by the presence of switching costs, that is, one time costs facing the buyer of switching from one supplier's products to another's. If these switching costs are high, then new entrants must offer a major improvement in cost or performance in order for the buyer to switch from an incumbent.

Expected Retaliation. If a competitor considering entering a market believes that the retaliation of an existing firm will be so great as to prevent entry, or will mean that entry would be too costly, then this is also a barrier. For example, entering the breakfast cereal market to compete with Kelloggs would be unwise unless careful attention was paid to a strategy to avoid retaliation.

Legislation or Government Action. The last major source of entry barriers is government policy. Government can limit or even foreclose entry into industries with such controls as licensing requirements and limits on access to raw materials. The most obvious example of the way in which government action can influence competitive activity was in the command economies of communist countries. More subtle government restrictions on entry can stem from controls such as air and water pollution standards and product safety and efficacy regulations. For example, pollution control requirements can increase the capital needed for entry and the required technological sophistication and even the optional scale of facilities.

(2) THREAT OF SUBSTITUTION

Substitutes products or services can limit the potential returns of an industry by placing a ceiling on the prices firms in the industry can profitably charged. Unless it can upgrade the quality of the product or differentiate it somehow, e.g. via marketing mix, the industry will suffer in earnings and possibly in growth. For example, sugar producers confronted with the large-scale commercialization of high fructose corn syrup, a sugar substitute rendering sugar producer learning this lesson today. As you can see, these substitutes not only limit profits in normal times, but they also reduce the bonanza an industry can reap in boom times.

Identification of potential substitutes that can perform the same function as per the products of the industry, can be quite subtle and difficult tasks. For example, securities brokers are being increasingly confronted with such substitutes as real estate, insurance, money market funds and other ways for individual to invest capital, accentuated in importance by the poor performance of the equity markets.

Substitute products that deserved the most attention strategically are those that are;

(1) subject to trends improving their price-performance trade off with the industry's product,

(2) produced by industries earning high profits, or

(3) currently being marketed more aggressively than in the past.

Substitutes often come into play if some development increases competition in their industries and causes prices reduction or performance improvement.

(3) & (4) POWERFUL BUYERS AND SUPPLIERS

Suppliers can exert bargaining power on participants in an industry by raising prices or reducing the quality of purchased goods or services. Buyers compete with the industry by forcing down prices, bargaining for higher quality or more services and playing competitors against each other - all at the expense of industry profitability. These two forces are considered together because they are linked as all organization have to obtain resources and provide goods or services. Moreover, buyers and sellers can have similar effects in constraining the strategic freedom of an organization and in influencing the margins of that organization. However, it is important to remember that different types of suppliers and buyers will have different impact for different organizations in a different manners.

So, **WHEN** is supplier and buyer powers likely to be important ?

SUPPLIER POWER is likely to be high when:

- There is a concentration of suppliers rather than a fragmented source of supply.
- The 'switching costs' from one supplier to another in the industry are high, perhaps because a manufacturer's processes are dependent on the specialist products of a supplier, or a product is clearly differentiated.
- The brand of the supplier is powerful. This link to 'switching costs' because, as might be the case for consumer goods, a retailer might not be able to do without a particular brand.
- There is the possibility of the supplier integrating forward if it does not obtain the prices, and hence the margins, it seeks.
- The supplier's customers are of little importance to the supplier, in which case the supplier is not likely to regard the long-term future of the customers as particularly important.

Buyer power is likely to be high when:

- There is a concentration of buyers, particularly if the volume purchases of the buyers are high.
- There are alternative sources of supply, perhaps because the product required is undifferentiated between suppliers or, as for many public-sector operations in the 1980s, the

deregulation of markets spawns new competitors.

- The component or material cost is a high percentage of the total cost. Buyers will then be likely to 'shop around' to get the best price and therefore 'squeeze' the suppliers.
- There is a threat of backward integration by the buyer if satisfactory prices or suppliers cannot be obtained.

Government As A Force In Industry Competition

Government agencies, as described in previous section plays a prominent role in determining entry or exit barrier. Besides, it is also recognized as potentially influencing many if not all aspects of industry structure both directly and indirectly. It is easily understandable that in many industries , government is a buyer or supplier an can affect industry competition by the policies it adopts. For example, government play a crucial role as a buyer of spare-parts and engine for PROTON in Malaysia. Though at times, it's role as a supplier or buyer is determined more by political . factors than by economic circumstances.

Government regulations, subsidies and other means, can set limits on the behavior of firms as suppliers or buyers, and affect the position of an industry with substitutes. For example, government control of natural gas is quickly eliminating acetylene as a chemical feedstock. Thus, no structural analysis is complete without a diagnosis of how present and future government policy, at all levels. For purposes of strategic analysis, it is usually more illuminating to consider how government affects competition through the five competitive forces than to consider it as a force itself.

(5) INDUSTRY COMPETITIVE RIVALRY

Rivalry among the firms in the industry can often be the main driving force in determining both day to day operations and firms' long term business strategy. In fact, intense competition may shape the organization in such a manner that "Change Management" and quick market responses win. Thus, it is of major concerned to firms in that particular industry to know what is the intensity of the industry competitive rivalry and how can it be influenced.

The most competitive markets will be those in which entry is likely, substitutes threats, high level of both buyers and suppliers' power as described in the previous paragraphs. There are other factors which also affect competitive rivalry;

- The balance of the industry competitors. Whatever the number, where competitors are of roughly equal size, there is the danger of intense competition as one competitor attempts to gain dominance over another.
- Market undergo slow growth. The rivalry tends to increase

when the market is entering maturity and competitors are keen to establish themselves as market leader.

- <u>High fixed costs.</u> Perhaps through high capital intensity or high costs of storage, are likely to result in competitors cutting prices to obtain the turnover required. This can result in price wars and very low margin operations.
- <u>Excess capacity.</u> Large excess in capacity causes the competitor making such an addition to create at least short term over-capacity and increased competition.
- <u>Undifferentiated products.</u> In a commodity market, where products and services are not differentiated, there is little to stop customers switching between competitors.
- <u>Enhanced competitiveness via acquisition.</u> Acquisition of weaker companies by stronger companies results in the provision of funds to improve the competitive standing of such firms, enhancing their ability to compete more effectively.
- <u>High exit barrier.</u> Where there are high exit barriers in an industry, there is again likely to be the persistence of excess capacity and consequently increased competition.