

The needs to have Competitive Advantage

II. Threat of Substitutes. In Porter's model, substitute products refer to products in other industries. To the economist, a threat of substitutes exists when a product's demand is affected by the price change of a substitute product. A product's **price elasticity** is affected by substitute products - as more substitutes become available, the demand becomes more elastic since customers have more alternatives. A close substitute product constrains the ability of firms in an industry to raise prices.

The competition engendered by a Threat of Substitute comes from products outside the industry. The price of aluminum beverage cans is constrained by the price of glass bottles, steel cans, and plastic containers. These containers are substitutes, yet they are not rivals in the aluminum can industry. To the manufacturer of automobile tires, tire retreads are a substitute. Today, new tires are not so expensive that car owners give much consideration to retreading old tires. But in the trucking industry new tires are expensive and tires must be replaced often. In the truck tire market, retreading remains a viable substitute industry.

In the disposable diaper industry, cloth diapers are a substitute and their prices constrain the price of disposables. While the treat of substitutes typically impacts an industry through price competition, there can be other concerns in assessing the threat of substitutes. Consider the

substitutability of different types of TV transmission: local station transmission to home TV antennas via the airways versus transmission via cable, satellite, and telephone lines. The new technologies available and the changing structure of the entertainment media are contributing to competition among these substitute means of connecting the home to entertainment. Except in remote areas it is unlikely that cable TV could compete with free TV from an aerial without the greater diversity of entertainment that it affords the customer

III. Buyer Power. The power of buyers is the impact that customers have on a producing industry. In general, when buyer power is strong, the relationship to the producing industry is near to what an economist terms a **monophony** - a market in which there are many suppliers and one buyer. Under such market conditions, the buyer sets the price. In reality few pure monopsonies exist, but frequently there is some asymmetry between a producing industry and buyers. The following tables outline some factors that determine buyer power.

IV. Supplier Power. A producing industry requires raw materials - labor, components, and other supplies. This requirement leads to buyer-supplier relationships between the industry and the firms that provide it the raw materials used to create products. Suppliers, if powerful, can exert an influence on the producing industry, such as selling raw materials at a high price to capture some of the industry's profits. The following tables outline some factors that determine supplier power.

Buyers are Powerful if: Example. Buyers are concentrated - there are a few buyers with significant market share DOD

purchases from defense contractors Buyers purchase a significant proportion of output - distribution of purchases or if the product is standardized Circuit City and Sears' large retail market provides power over appliance manufacturers Buyers possess a credible backward integration threat - can threaten to buy producing firm or rival Large auto manufacturers' purchases of tires

Buyers are Weak if: Example. Producers threaten forward integration - producer can take over own distribution/retailing. Movie-producing companies have integrated forward to acquire theaters Significant buyer switching costs - products not standardized and buyer cannot easily switch to another product IBM's 360 system strategy in the 1960's Buyers are fragmented (many, different) - no buyer has any particular influence on product or price Most consumer products Producers supply critical portions of buyers' input - distribution of purchases Intel's relationship with PC manufacturers

Suppliers are Powerful if: Example. Credible forward integration threat by suppliers Baxter International, manufacturer of hospital supplies, acquired American Hospital Supply, a distributor

V. Barriers to Entry / Threat of Entry. It is not only incumbent rivals that pose a threat to firms in an industry; the possibility that new firms may enter the industry also affects competition. In theory, any firm should be able to enter and exit a market, and if free entry and exit exists, then profits always should be nominal. In reality, however, industries possess characteristics that protect the high profit levels of firms in the market and inhibit additional rivals from

entering the market. These are **barriers to entry**.

Barriers to entry are more than the normal equilibrium adjustments that markets typically make. For example, when industry profits increase, we would expect additional firms to enter the market to take advantage of the high profit levels, over time driving down profits for all firms in the industry. When profits decrease, we would expect some firms to exit the market thus restoring market equilibrium. Falling prices, or the expectation that future prices will fall, deters rivals from entering a market. Firms also may be reluctant to enter markets that are extremely uncertain, especially if entering involves expensive start-up costs. These are normal accommodations to market conditions. But if firms individually (collective action would be illegal collusion) keep prices artificially low as a strategy to prevent potential entrants from entering the market, such **entry-detering pricing** establishes a barrier. Barriers to entry are unique industry characteristics that define the industry. Barriers reduce the rate of entry of new firms, thus maintaining a level of profits for those already in the industry. From a strategic perspective, barriers can be created or exploited to enhance a firm's competitive advantage. Barriers to entry arise from several sources:

1. **Government creates barriers.** Although the principal role of the government in a market is to preserve competition through anti-trust actions, government also restricts competition through the granting of monopolies and through regulation. Industries such as utilities are considered natural monopolies because it has been more efficient to have one electric company provide Suppliers concentrated Drug

industry's relationship to hospitals
Significant cost to switch suppliers
Microsoft's relationship with PC
manufacturers Customers Powerful Boycott
of grocery stores selling non-union picked
grapes

Suppliers are Weak if: Example

Many competitive suppliers - product is
standardized Tire industry relationship to
automobile Manufacturers Purchase
commodity products Grocery store brand
label products Credible backward
integration threat by purchasers Timber
producers relationship to paper companies.

Concentrated purchasers Garment industry
relationship to major department stores
Customers Weak Travel agents' relationship
to airlines because it has been more efficient
to have one electric company provide power
to a locality than to permit many electric
companies to compete in a local market, to
restrain utilities from exploiting this
advantage, government permits a monopoly,
but regulates the industry. Illustrative of
this kind of barrier to entry is the local cable
company. The franchise to a cable provider
may be granted by competitive bidding, but
once the franchise is awarded by a
community a monopoly is created. Local
governments were not effective in monitoring
price gouging by cable operators, so the
federal government has enacted legislation
to review and restrict prices.

The regulatory authority of the government
in restricting competition is historically
evident in the banking industry. Until the
1970's, the markets that banks could enter
were limited by state governments. As a
result, most banks were local commercial
and retail banking facilities. Banks
competed through strategies that

emphasized simple marketing devices such
as awarding toasters to new customers for
opening a checking account. When banks
were deregulated, banks were permitted to
cross state boundaries and expand their
markets. Deregulation of banks intensified
rivalry and created uncertainty for banks as
they attempted to maintain market share. In
the late 1970's, the strategy of banks shifted
from simple marketing tactics to mergers
and geographic expansion as rivals
attempted to expand markets.

2. Patents and proprietary knowledge serve to restrict entry into an industry.

Ideas and knowledge that provide
competitive advantages are treated as
private property when patented, preventing
others from using the knowledge and thus
creating a barrier to entry. Edwin Land
introduced the Polaroid camera in 1947 and
held a monopoly in the instant photography
industry. In 1975, Kodak attempted to enter
the instant camera market and sold a
comparable camera. Polaroid sued for patent
infringement and won, keeping Kodak out of
the instant camera industry.

3. Asset specificity inhibits entry into an industry.

Asset specificity is the extent to
which the firm's assets can be utilized to
produce a different product. When an
industry requires highly specialized
technology or plants and equipment,
potential entrants are reluctant to commit to
acquiring specialized assets that cannot be
sold or converted into other uses if the
venture fails. Asset specificity provides a
barrier to entry for two reasons: First, when
firms already hold specialized assets they
fiercely resist efforts by others from taking
their market share. New entrants can
anticipate aggressive rivalry. For example,
Kodak had much capital invested in its

photographic equipment business and aggressively resisted efforts by Fuji to intrude in its market.

These assets are both large and industry specific. The second reason is that potential entrants are reluctant to make investments in highly specialized assets.

4. Organizational (Internal) Economies of Scale. The most cost efficient level of production is termed **Minimum Efficient Scale** (MES). This is the point at which unit costs for production are at minimum - i.e., the most cost efficient level of production. If MES for firms in an industry is known, then we can determine the amount of market share necessary for low cost entry or cost parity with rivals. For example, in long distance communications roughly 10% of the market is necessary for MES. If sales for a long distance operator fail to reach 10% of the market, the firm is not competitive.

The existence of such an economy of scale creates a barrier to entry. The greater the difference between industry MES and entry unit costs, the greater the barrier to entry. so industries with high MES deter entry of small, start-up businesses. To operate at less than MES there must be a consideration that permits the firm to sell at a premium price - such as product differentiation or local monopoly. Barriers to exit work similarly to barriers to entry. Exit barriers limit the ability of a firm to leave the market and can exacerbate rivalry - unable to leave the industry, a firm must compete. Some of an industry's entry and exit barriers can be summarized as follows:

DYNAMIC NATURE OF INDUSTRY RIVALRY

Our descriptive and analytic models of industry tend to examine the industry at a

given state. The nature and fascination of business is that it is not static. While we are prone to generalize, for example, list GM, Ford, and Chrysler as the "Big 3" and assume their dominance, we also have seen the automobile industry change. Currently, the entertainment and communications industries are in flux. Phone companies, computer firms, and entertainment are merging and forming strategic alliances that re-map the information terrain. Schumpeter and, more recently, Porter have attempted to move the understanding of industry competition from a static economic or industry organization model to an emphasis on the interdependence of forces as dynamic, or *punctuated equilibrium*, as Porter terms it. In Schumpeter's and Porter's view the dynamism of markets is driven by innovation. We can envision these forces at work as we examine the following changes:



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