Business Analysis for Engineers
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Lecture-24
Industry Analysis

Good morning. Today's class, will be about understanding a framework, that is popularly used to characterise an industry. Any strategy exercise, is always a multi-stakeholder approach. Organisations cannot strategize, by analysing only one input, or one stakeholder, for that matter. It needs to realise the fact that, businesses that are successful, are mindful of the fact that, there is more than one stakeholder, who is responsible for the success or failure of business.

So, a stakeholder means, the customer, the employees of an organisation, the suppliers, the existing competitors in the industry, the government regulators. So, it is a mix of various entities, who influence the way in which, an industry is organised. So, when we do a multi-stakeholder approach, from a strategic perspective, it becomes very necessary to analyse these stakeholders. And, at times it is very difficult to analyse, each and every stakeholder.

But at least, we have a broad classification by which we can say that, a certain set of stakeholders are internal, and a certain set of stakeholders are external. So, you have an internal stakeholder community, and an external stakeholder community. And, each of them need to be analysed. And, when you do an analysis, there must be some structured way in which, you can conduct this analysis. So that, the output of such an analysis, is a critical input to strategize various options, that is available for a business.

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Now, external stakeholder means, it could be the government, it could be the society, it could be the regulators, it could be the industry itself in which, the business is operating. As again internal stakeholders, which primarily is the company itself. The employees of the organisation, or also to a certain extent, the processes of the firm itself, these are internal to the entity. Now, in today's class, we are concerned about, a very critical external stakeholder, namely the industry.

For which, there are a number of models that are available to understand, how an industry is characterised. The most popularly used model is, the Michael Porter's model, which presents a competitive model for Industry Structure Analysis. Now, before we go to understand, what this model is all about, let me first define, what an Industry is.

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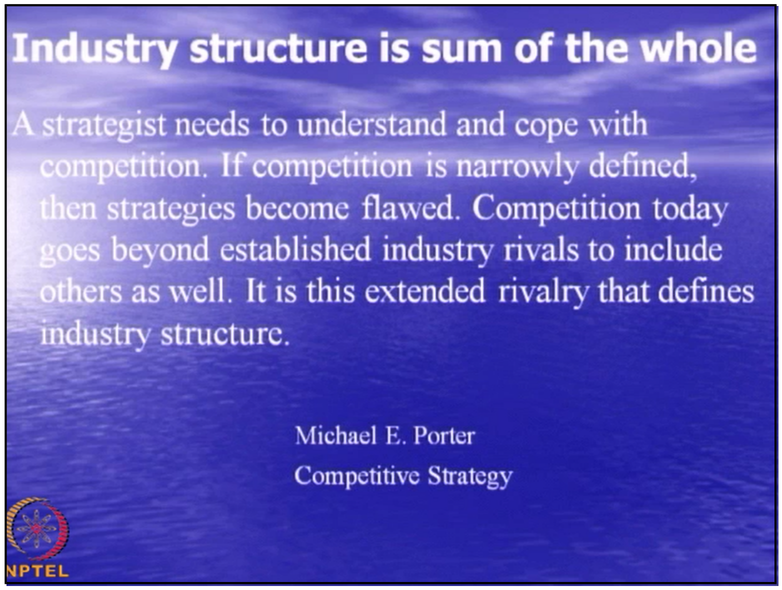

Because, more often than not, I find a lot of students, getting confused between the words, industry and a single company, a single entity, a single business. And, they use these interchangeably as well. The technical, but not a textbook definition of an industry is, a group of businesses that are engaged, in similar line of activities, they constitute an industry. For example, the Automobile Industry. The automobile industry is very broad. It means, it would include two wheelers, it could include three wheelers, it could include four wheelers.

Now, if we are going to narrow down and say, I am going to talk about, the four wheeler automobile industry. Then, it means, I am talking about all the firms, that are engaged in manufacturing and selling cars. So, it would be a Maruti, it would be a Tata Motors, it would be a Ford or a Hyundai. So, all of these individual corporations, who are linked by a common thread, that they are manufacturing and selling cars. They constitute, the four wheeler automobile industry.

Now, if this is what is an industry, then you will understand that, an industry is sum of all these players. And, if there is a necessity to understand, how each of these player's influence. And, in the process, characterise the way in which, an industry operates in a business environment. It would be a strategic failure, if we just very narrowly view an industry, and define competition in a narrow sense that way, then we will be limiting our strategic options. The strategic directions, that emerge out of such a narrow perspective, will be flawed

And hence, it is not safe to assume that, the strategies that evolved out of such a narrow perspective, are the best. So, we need to broaden our strategic thinking, to include not only the firm, but also the competition to the firm. In short, we need to include, the industry per say, when we do an analysis to strategize, the options that is available. Now, it is this extended rivalry, that Michael Porter says, defines the industry structure. And, it is this structure, that we need to understand, through a structured framework for us, to fully appreciate the nuances, that characterise the industry structure.

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Now, what we do in this model is, we try to break an industry into various parts. An industry by itself, has some critical parts, when put together, forms the entire body called, the industry. Now, when we do this, we definitely do not miss, certain critical inputs or critical parts, that we will have to analyse, when we understand the industry structure. Which, we otherwise would have missed, had we just followed, a narrow perspective of analysing an industry. Now, what this model puts in place is, when we split the industry into various parts, and understand how these parts behave.

And, as a result of such a behaviour, how the industry itself behaves. And, in the process as somebody who is an existing player in the industry, or somebody who wants to enter into the industry as a new player, I would be able to understand the competitiveness of the industry. And, if I am able to understand the competitiveness of the industry, I to a reasonable extent can measure, the profitability of the industry. The reason being, I can come to a conclusion, whether this industry is attractive, to either enter, or to even continue business.

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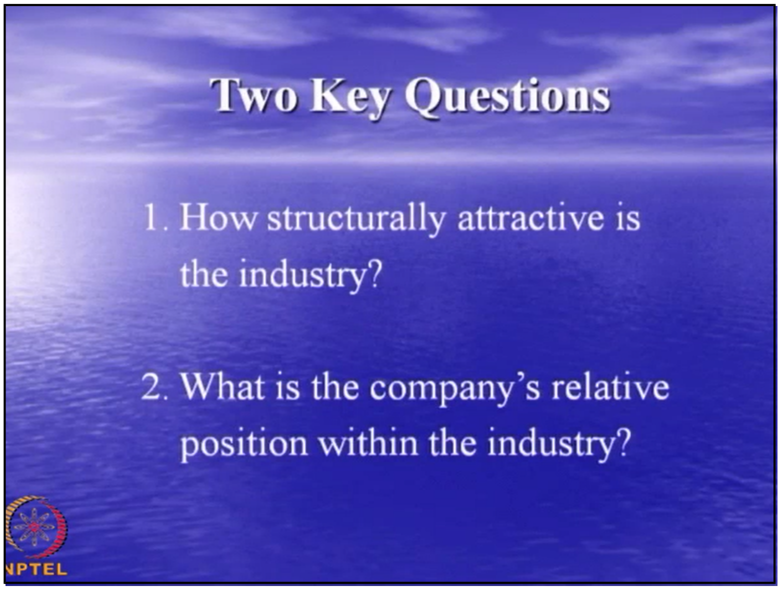

Now, it is for this purpose that, I raised two questions, which are broadly the key questions for which, the Porter's 5-Forces Industry Analysis provide answers. The first question is, how structurally attractive is this industry. And, within the industry, what is the relative position, that as a company I have. And, these two questions throw a lot of answers, which will set the strategic direction.

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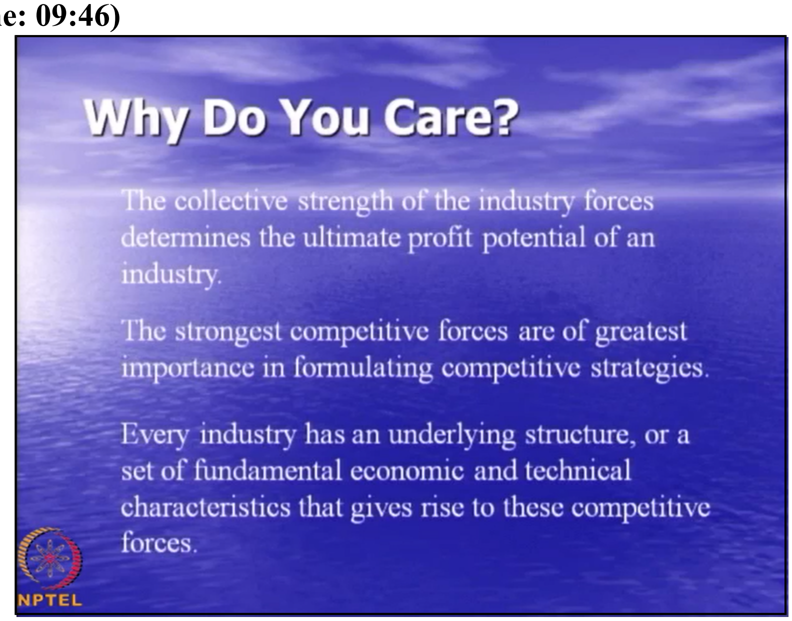

Now, why is that, these different parts. I already mentioned, that there are 5-Forces. And, as we go I will explain, what these 5-Forces are. Now, it is important for us to understand that, each of these parts, when collectively viewed, it determines the profit potential of an industry. The industry as I told you, is sum of all these parts. And, all of these aggregated together, characterise the very basis on which, the industry is operational. And, that is why, you find that in some industries, because the behaviour of these individual parts is different.

The profitability or the profit potential of that industry is more. As again, some industries in which, there is so much saturation, that the profit potential might tend to go down. The parts of these industries, remain the same. But, the way in which they behave, particularly within an industry depends on, what type of industry we are analysing. And, in the process when we see that there are some forces, that significantly influence the characteristic of an industry. Then, when it comes to framing strategies, we should focus our efforts on, those strong forces of significant importance.

Now, the underlying assumption that we have made is that, every industry, whether it is an automobile industry, or a steel industry, or a food and beverages, or an aircraft manufacturing, whatever be the industry, there is a set of underlying parameters, which governs, or which forms, the very DNA of the industry. And, each of them, will have their own technical characteristics. And, it is these characteristics, that we are interested in understanding. And, how these characteristics, define the industry and the process also, set the competitive forces in motion.

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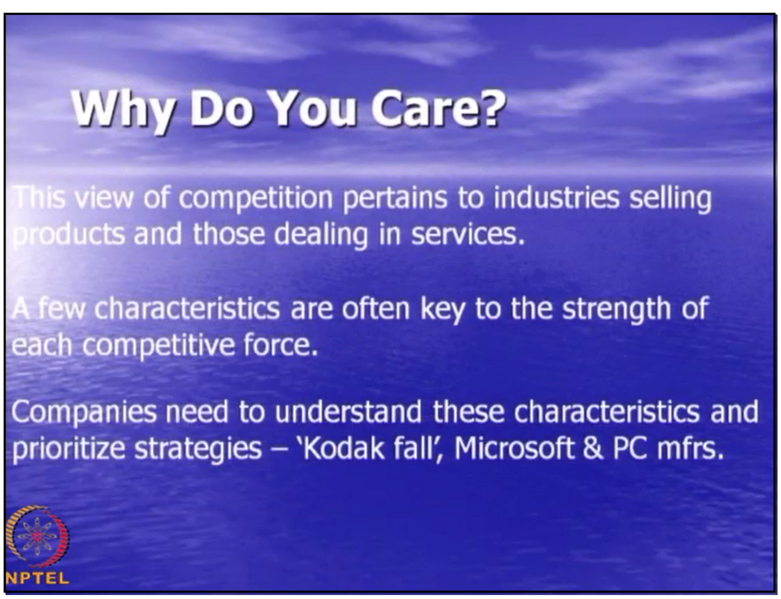

Now, it is very important that companies need to understand these characteristics. Because, only businesses that can understand, the forces that govern the industry structure, will be able to prioritise their strategies. Eastman Kodak or Kodak, failed to understand the dynamics of the industry, what was happening to the industry. It is not only these 5-Forces within an industry, but also something that happens outside the industry, that changes the way in which these 5-Forces behave, is also equally important.

The failure of Kodak, is the failure of its understanding the characteristics, that pertained to its industry. As a result of which, it was a huge failure. Likewise, contrast that with PC manufacturers. The transition of IBM. You can see an IBM in 1970, and an IBM today, you can understand the transformation, and the transition, that has happened to IBM.

One of the main reason is, it was able to understand the way in which, the PC industry was making a transition, from the age of mainframes, today the age of Handhelds, and Desktops, and Laptops. So, you can understand that, every entity, that needs to be a leader in its industry, needs to understand these key characteristics, that pertains to selling its products or services. And, the strength of each of these characteristic, how it influences the industry behaviour.

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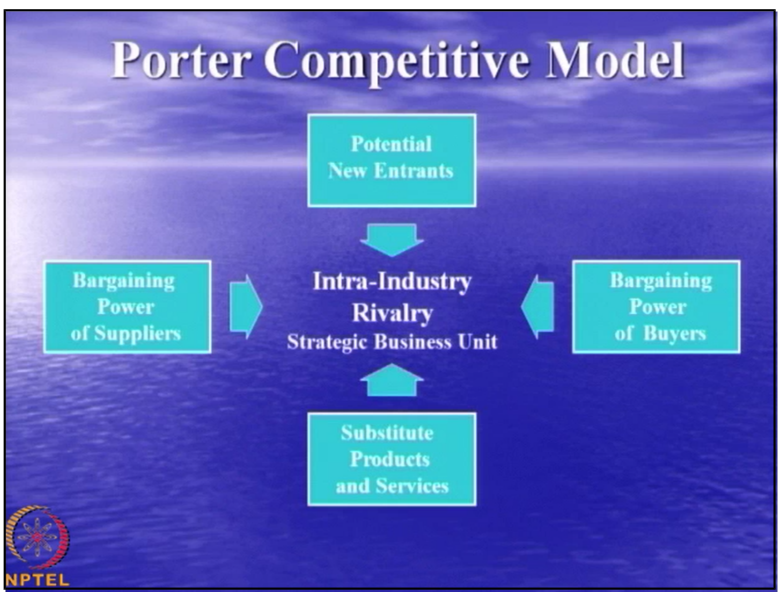

Now, what are these five factors. Now, Porter's Competitive Model of Industry Analysis, clearly identifies 5-Forces, that it believes, strongly influences the industry. One is the potential new entrant. The other is the bargaining power of buyers. The third, the bargaining power of suppliers. Fourth, substitute products and services. And, fifth, the intra-industry rivalry itself. That is, the rivalry within those, existing players in an industry. Now, I will try to expand, each of these forces. And, how each of these forces, influence the industry.

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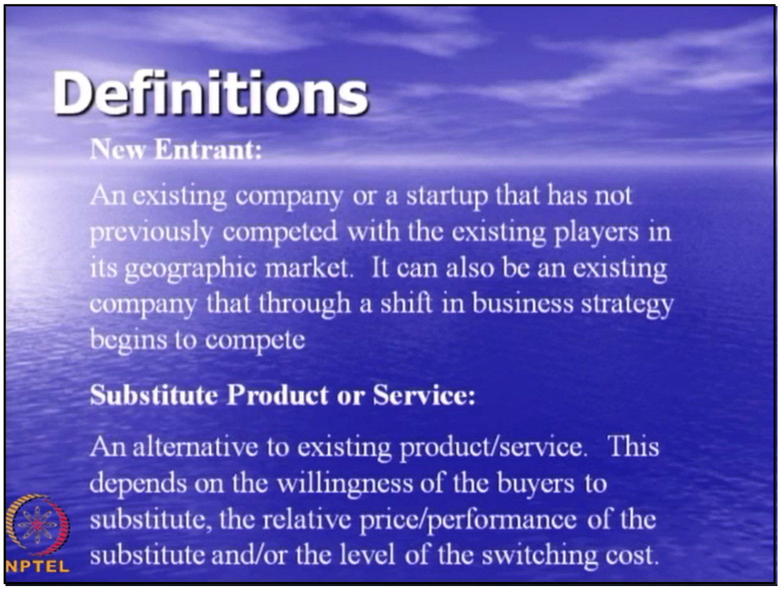

But, before we do that, let me just give you a quick overview of, a few definitions that you need to understand. Remember, the first force was related to, a new entrant. Now, a new entrant could be an existing company, or a start-up company, which has not previously competed with the existing players, in a given market space. For example, Facebook entered the social networking, Pepsi entered into the bottle water industry.

Now, these are all new entrants to a new industry. And, Pepsi is an existing player, in the food and beverages industry. And, bottle water is a business in the food and beverage industry. So, I am just giving you two examples, for you to understand, that a new entrant could be, an existing player in an industry, who was entering into a new market space. Or, in the case, the example that I gave was, Pepsi or a Coke. As, against a new entrant, into the industry itself. For example, how Facebook entered the, social networking industry.

The substitute product or service is again, an alternative, that exists for a product or a service, that it be sold or delivered. Now, how do I qualify, that an existing product or a service is a substitute. If there are compelling reasons enough for a customer, to shift to an alternative choice, because the customer believes, that the relative price, performance, of the alternate choice is higher, and that there is no switching costs involved, then this alternate choice, is the substitute product or service.

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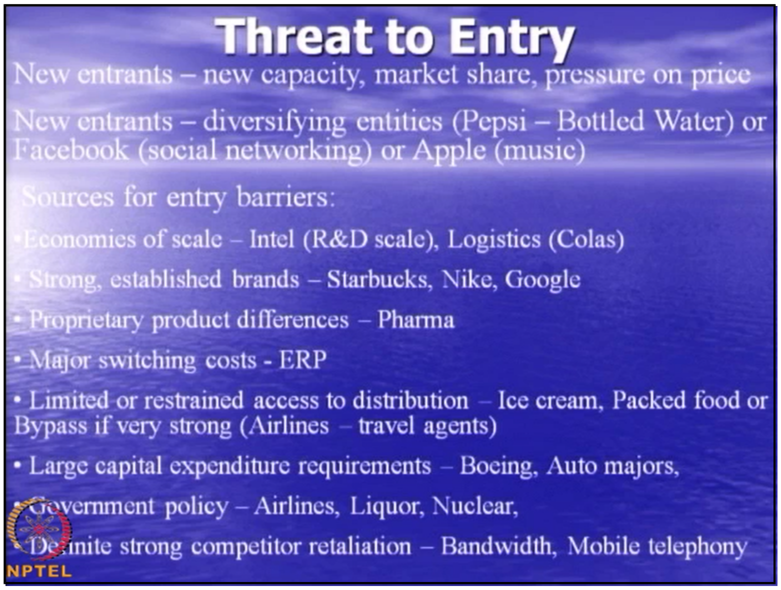

Now, let us begin, by understanding these 5-Forces, independently. The first force. Now, before we explain this, the basic idea of this 5-Forces model, is to see, how each of these forces, influence the industry. And, if you feel that each force, positively or negatively influences the industry, relative to your position in the industry. That is, if you are an existing player, you have to see whether this force, is to your advantage or disadvantage.

Or, if you are a new player, you will have to understand, whether each of these forces, is again to your advantage, or your disadvantage. And, the sum of all these pros and cons for each of these force, will measure your relative position within the industry, either as a player, or as a new entrant. When I give you examples in each of these forces, you will begin to understand, what I am trying to explain. Now, the first force is, threat to entry. Threat from new entrants.

Now, why is this very important. Now, assume that, you are an existing player. And, if you have an industry, which by its very design, protects you from new entrants, then your position is better-off. So, you can say that, the threat, that I will receive, from a potential new entrant is low.

If I am in an industry, which is characterised by some forces, with significantly impact this threat to entrant factor, the result of which, I am able to enjoy some immunity.

Because, it is very difficult for a new entrant, to enter into this industry. Now, why do new entrants get into an industry. They find that, there is a lot of potential, there is a lot of market, that is untapped. Or, big corporate houses, have a lot of capacity, have a lot of resources on hand, that they would like to invest in, new businesses. Or, some businesses would like to exit from their existing businesses, and enter into new businesses. Now, there are various reasons, why entities want to start new operations.

As I explained before, diversifying entities, like Pepsi or a Coke, which was into the cola industry, also enter into the bottle water industry. They are also into the, snacks industry. Or, Facebook was a new entrant into the, social networking industry. Or, apple, though it started in the pc industry, it revolutionised the music industry itself. And, it was a different new entrant, into the music industry. So, different companies have different reasons. As a result of which, as an existing player in an industry, I might get new players, entering into the industry.

Now, if I am an existing player in an industry, when would I think that, the sources of entry barriers are very strong. What do I mean by that? See, I had already told you that, each industry at the fundamental level, will have these 5-Forces. But, the way in which, these 5-Forces behave, depends on the industry in which, we are doing this analysis. So, a particular source could build, high entry barriers for a new entrant. Or, a particular industry will have, lower entry barrier for new entrants.

So, which are all those influencing parameters, which either build strong or weak entry barriers. And, if the entry barriers are very strong, then for somebody who is already a player in the industry, the relative impact will be less. Because, the threat that I will get from a new entrant is minimal. Because, the entry barriers are very strong. Now, when will an entry barrier be strong or weak. We will just break, the various sources of entry barriers, to understand this. For example, economies of scale.

Now, what do we mean by economies of scale. It means that, you need a wider base over which, your major capital expenditure or fixed costs will get distributed. For example, let us say, the example that I have given is Intel. Now, why is Intel successful. Now, why is that, it is difficult for a new entrant, to enter into this industry. The economies of scale, that Intel has built primarily is from the R&D, that it has developed. You need, so much of research and development.

And, that R&D expenditure has to be spread over a wider base, which is difficult, unless there is enough R&D expenditure, that is available for a new entrant. It is very difficult, for a new entrant to derive benefit, from these economies of scale. Another example could be, let us say, the logistics, or the supply chain, or the distribution channel. For example, the Coca-Cola, or the PepsiCo. Now, where do they derive, their economies of scale.

They have a fully integrated distribution system, which is very difficult to replicate by a new entrant. And, it requires, huge economies of scale to build, such a distribution system. As a result of which, if I am a Coca-Cola, or if I am a PepsiCo, I feel that, the threat from a new entrant, because of the scale that I have built, in the distribution, is low. Because, a new entrant cannot achieve that scale economy. As a result of which, my position, my relative to a new entrant, is better.

Another source of entry barrier could be, the brand itself. For example, let us say, we are talking about premium coffee. Starbucks is a very powerful brand. Or, here you, a Cafe Coffee Day is a powerful brand. A Barista is a powerful brand. Likewise, Nike is a powerful. If you go-to search engine, Google is a powerful brand. So, there are inherent advantages, that google has, or a Nike has, which it gets from the power of its brand. And, to that extent, it is difficult for a new brand, to enter into a search engine industry, or the footwear industry, or the premium coffee industry.

And of course, if it is going to be another powerful brand, then it no longer is a strong entry barrier. But, for existing powerful brands, there is an inherent weak, an inherent advantage, by way of a strong entry barrier. Which is built because, such brands are very powerful, that existing customers would not shift to an alternate brand. So, this is one source of entry barrier, that gets built because, the brand is very strong. Another entry barrier is a very clear case of, proprietary product differences.

And, this is very common in the pharma industry. And, if you are a pharma player, it could be a Novartis, or you could be an Eli Lilly, you have proprietary knowledge by way of patents, which does not allow any new entrant, to enter into that space. Because, you have a patent, that protects you. As a result of which, the threat from a new entrant is little. There is literally no threat. So, there is, this characteristic feature, which is common in the pharma industry, because of the proprietary knowledge, that each of the players have, builds a very strong entry barrier.

Another source of entry barrier, that gets built into an industry, is the switching cost. Why switching cost is an entry barrier. And again, a classic example is the ERP Industry, the Enterprise Resource Planning Industry. Suppose, your firm works on an Oracle platform. Another firm works on a SAP platform. So, you have all of your infrastructure, the training of the employees, all suited towards either a SAP platform, or an Oracle platform.

So, suppose I am SAP. And, I am just trying to see, whether in this industry, the threat from a new entrant is high or low. So immediately, I would like to see whether, the cost of switching from SAP to Oracle, or any other ERP, is high or low. If the cost of switching from an existing ERP, to another ERP, is very high, then that is an inherent entry barrier. Because, the customers would not be willing to invest, such huge switching costs, unless there are compelling reasons, unless the switching cost benefit outweighs.

Then, as somebody who has, major switching cost built into the business model, I would feel that, the threat from a new entrant is low. So, that is why switching cost, is another source of entry barrier. Access to distribution channel, is also another entry barrier. And, this is very, very important, especially when it comes to the retail industry. And, that is why you find, the ice cream, or the pack food industry. If you go to any of these shopping malls, one of the main, the key success factor for the retail industry is, shelf space.

If you do not have shelf space, in the retail industry, it is very difficult to push your products. And, this is again, linked to the supply chain management, linked to the distribution network that you have. And, if a new entrant is not able to access, such competitive distribution networks, then for existing players, the threat from a new entrant is very low. Because, the access distribution has built a strong entry barrier. Unless, some radical change happens into the industry, that makes this distribution channel itself, irrelevant.

And, this happened in the airlines industry. In many cases, now you find that, the role of the travel agent itself is diminishing. How? Because, the airlines industry, or a different intermediary has emerged, whereby you can buy your tickets online. And, the role of travel agents is getting diminished. So, if I am in the travel industry, and more specifically the travel agent, then I would feel that, the threat from a new entrant is very high. Because, no longer is this distribution channel limited.

No longer, new entrants been restrained, from accessing these distribution channels. Because, an alternate distribution channel itself, has emerged. So, accessed distribution channels, is also a source of entry barrier. Now, the main important entry barrier, is the capital expenditure. If the industry requires huge capital expenditure, which not many new entrants can afford, then existing players will feel that, capital expenditure by itself, has built a strong entry barrier.

Which means, it need not worry about, a lot of players trying to get into the industry. Because, by very nature, the industry is capitally intense. Major examples are the, aircraft manufacturing industry. And, that is why, you do not find a lot of competition, in the aircraft manufacturing industry. Though, there is intense competition, in terms of the number of players in the industry, you do not find many. You just find, a Boeing, or an Airbus, or a Lockheed. Why? Because, the industry is extremely capitally intensive.

And, also the automobile industry, or the steel industry. These are all industries, that are capitally intensive. And because, they are capital intensive, there are some inherent entry barriers. I am not saying, all capital intensive industries, do not have any threat from new entrant. I am just trying to say that, there are some inherent advantages of being, a first mover in a capital intensive industry. Because, since it is capitally intensive, the threat from new entrant is relatively lower.

As a source of an entry barrier, it provides a strong entry barrier. As a result of which, the threat from a new entrant is minimum. There are some industries in which, the government policy itself, is a source of an entry barrier. And, these are industries, which are highly and heavily regulated. The Nuclear Industry, for that matter. Or, very recently, the FDI in Multi-Brand Retail. The Liquor Industry, the Airlines Industry. So, various industries, which are highly regulated, the government policy by itself, could be favourably or unfavourably disposed.

But, it is a source of an entry barrier. And, if it is favourably disposed, then it is providing high entry barriers. Which means, new players cannot easily enter. And, if it is not favourably disposed, then the threat from a new entrant is very high. The competitive retaliation within an industry itself, is a threat for a new entrant. Suppose, I want to enter into a new business. And, if this industry is prone to very strong retaliation from existing players, I would think twice, before I enter into this business. Mobile Telephone is a good example.

The bandwidth business is a very good example. Today, you find leased lines. Entering into the leased line business, suppose there is a new product offering, immediately there is a retaliation from existing players. So, the extent to which, the existing players can retaliate, is by itself, a source for an entry barrier. And this, from a new entrant point of view. Suppose, I am, remember we have to do this industry analysis, either as somebody who is inside the industry, or somebody who wants to enter into the industry. And, in this case, if I am somebody, who wants to enter into the industry.

And, if I feel that, if I enter into the industry, the retaliation from those existing in the industry is going to be very strong, then I would think twice. Which means, the source of entry barrier is very strong. So, this is about the threat to new entrants. Now, why are we doing this. This, we are doing, as I said before, to measure, to get an understanding. Suppose, I am an existing player in the industry. Are there different sources of entry barriers, which would allow, or restrict new entrants?

And, if the aggregate of these sources, are in such a way that, it builds a lot of entry barriers, then the threat I would have from a new entrant, is low. If the aggregate of all these factors, that influence the entry barriers, is positioned in such a way, that there is a lot of chance, that a new entrant can come in, then the threat from a new entrant is high. And this, I will have to do, as a player within the industry, to understand where I actually stand. Whether, I would be facing a lot of threat from new entrants or not. So, this is one first factor, to do an industry analysis.

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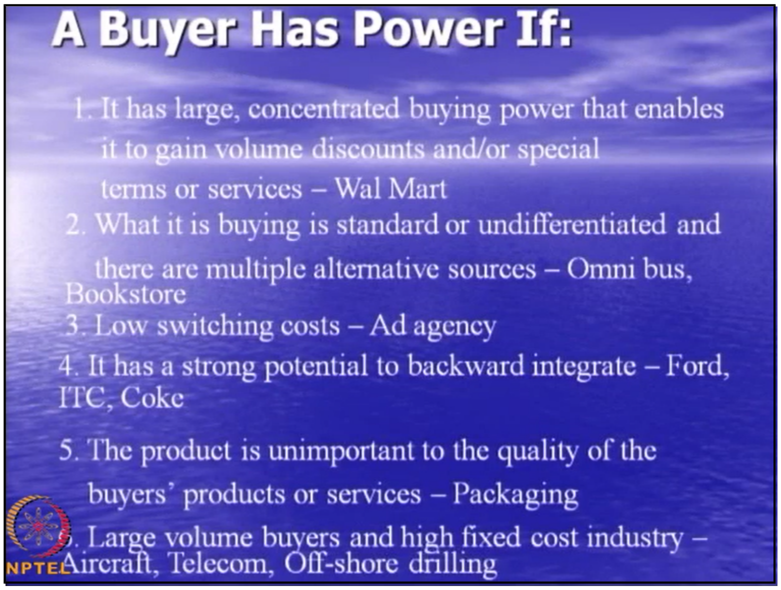

The next is the bargaining power of a buyer. Now, who is a buyer? A buyer is the end user, or the customer. And, the end user, could be a retail user, or could be an institutional customer. A buyer has some bargaining power. Now, when does the bargaining power of the buyer, is high or low. And, if it is high, how does that characterise the industry. If it is low, how does that characterise the industry, is the issue, that we would like to understand.

Now, when is the bargaining power of a buyer, very high. A buyer will have a high large bargaining power, if that buyer is concentrated in its buying power. As a result of which, it is able to gain, a lot of volume discounts. Now, what do I mean by this? Take for example, Walmart. Now, Walmart is a buyer for, from various vendors that it has. And, every supplier would like to sell its product, or its service, in a Walmart store. So, look at Walmart, store as a buyer. And, imagine the amount of bargaining power, that it will have.

Because, it has at its disposal, the power to buy in huge volumes. As a result of which, it can practically dictate terms, to its suppliers. And, now if we are talking about, the shopping mall industry, or the multi-brand retail industry, Walmart is clearly a leader. And, it knows that, it has higher bargaining power. So, it means, that it is relatively better placed, than somebody else, who wants to just start another competitive business, in the same industry. Because, it cannot command such volumes.

Another source, another way to see, whether the bargaining power of the buyer is high or low, is to see, what product or service that has been delivered. And, if that product is a standard product, or an undifferentiated product. For example, let us take the, Omnibus industry. The buyer is the normal passenger. Unless there is huge differentiation, for me going by, a particular bus X, or a particular bus Y, does not make a difference, if there is no differentiation at all.

And, in these cases, the buyer has a higher bargaining power. And, if I am in the Omnibus industry, as somebody running buses, I should know the fact, that a buyer has higher bargaining power. Because, I am delivering a service, that is not highly differentiated. And also, there are multiple options available for the buyer. As a result of which, the buyer can switch over from, my bus service, to another bus service. The same thing, as a bookstore. You have a landmark. You have an odyssey. You have a crossword.

Unless, the buying experience is unique and differentiated, and as long as if it is not, and if the product is standard, and there are no switching cost, then as a buyer, I can switch from one product or one service X, to another product or another service Y. And, it is in these cases, that you would say that the bargaining power of the buyer is high. And, for players in such an industry, they should be mindful of this fact. Now, when will again, the bargaining power of the buyer be high, if the switching costs are low.

Take for example, the Ad Agency Industry. Assume that, every ad agency is able to give the same level of service, in terms of creativity. So, I can easily switch from, Lintas, to an R K Swamy, or whichever is the ad agency. If I feel that, all the ad agencies, are in terms of the creative differentiation, they are the same, the switching cost is very low. Now, a buyer will have a high bargaining power, if the switching costs from shifting, to one service provider, or from one product to another service provider, or another product, is very low.

And, this as somebody, who is participating, a player in an industry, I should be mindful. A buyer will also have, a very high bargaining power, if it has the propensity to backward integrate. Now, what do I mean by backward integration. Take for example, Ford. It is in the business of manufacturing and selling cars. And, let us say, the core competency of Ford, is its engines. And then, the rest is all, assembly. The wiring. The auto component suppliers, give all those other components. It gets steel. It gets tyres, from elsewhere.

Now, when will Ford have a higher bargaining power, as a buyer of tyres, as a buyer of steel, as a buyer of other auto components. If it has the propensity to start, its own tyre manufacturing unit, its own steel manufacturing unit. For example, take the case of Tata. Tata Motors makes their own cars. And, if I am a supplier of steel, I know pretty well, that the buying power of Tata Motors, when it comes to getting steel from me, is very high. Because, it has its own Tata steel, from where it can buy.

Of course, there is no hard and fast rule that, Tata Motors should buy steel only from Tata steel. Because, this is a different business entity, that is a different business entity. And, both of them are competing fiercely, for their own profits. And suppose, I am steel authority of India. And, I am aggressively trying to push my steel for Tata Motors. Then, I should be mindful of the fact, that the bargaining power of Tata Motors is high because, it has its own steel manufacturing expertise, from the Tata Group.

So, this is what I mean by, the propensity, or even the existing backward integration. If you find that, firms can backward integrate, then you should realise that, these firms have higher bargaining power. Because, these firms, as your buyers, they have higher bargaining power. For example, ITC. If they are in the business of selling tobacco products, they can backward integrate and also get into the, other small services, small products, that get into the tobacco products.

Or, for example, Coke. They can backward integrate, which they are, to get into even the bottling industry. So, these are examples of how, the bargaining power of a buyer, because of its propensity to backward integrate is very high. The buyer also has a significant high bargaining power, if the product is very unimportant, to the buyer’s end product. For example, this is typical for packaging. Suppose, I am selling my product. And, packaging is just one component to it.

And, it is actually the product that is important, and not the packaging, that gets into the product. And, I am buying my packaging material, from some vendor. I will have more bargaining power. Because, for me, the packaging is not important. It is the product, that is important. So, I will have better negotiation powers, I have better bargaining powers, over the vendor, who supplies the packaging material. A buyer again, has a higher bargaining power, if they are large volume buyers. And especially, this is very, very critical, in high fixed cost industry.

And, that is why, you find in an aircraft industry. When India wants to buy aircrafts, the companies do not approach the Indian Government. The President of US, or President of France, talks to the Prime Minister of India. Because, we are talking about an Airbus, and a Boeing. So, you can understand, that the bargaining power is very high, if you are a buyer in an industry, that is also driven by volumes, and at the same time, high fixed costs. And, this is true, if you are in the Telecom Industry as well, or offshore drilling, Schlumberger.

So, these are cases, where the volume is also high, and at the same time, it is high fixed core industry, then the bargaining power of the buyer is very high. So, the second factor is bargaining power of the buyer. And, again here, you have to sit inside, if you are a player in this industry, to understand who has, the higher bargaining power. Now, if the buyer has the higher bargaining power, then the power shifts to the buyer, because he has other choices.

And, is it structurally attractive? If you want to enter into the industry, you will have to understand this, bargaining power of the buyer, before you want to enter into the industry, as a new entrant. So, the first factor was, threat from the new entrant. The second one is, the bargaining power of the buyer. So, in the next class, we will cover, the other forces. And then, take one example, to understand, how these 5-Forces, influence in industry. Thank you.