Business Analysis for Engineers
Prof. S. Vaidhyasubramaniam
Adjunct Professor, School of Law
SASTRA University-Thanjavur

Lecture -25
Industry Analysis & Sources of Strategy

The next force is that of, the bargaining power of the supplier. Now, any business requires inputs. Could be, in the form of a labour, or some components, parts, raw materials, or some services. And, the cost of the input, has a very significant impact, on the profitability of the business.

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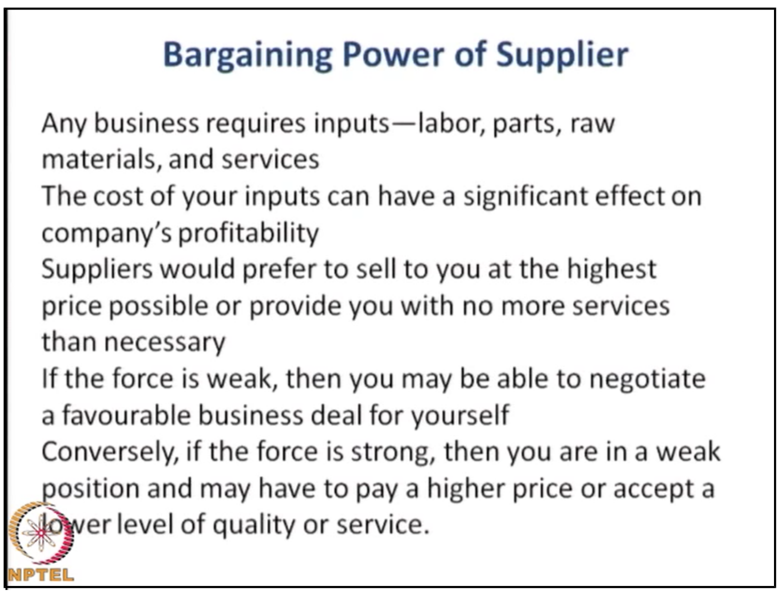
And, if this input comes from a vendor outside, then the vendor is always, you know, ready to



sell it at the highest price possible, or provide with know, more services than actually is necessary. Now, if a vendor is a critical part of your business ecosystem, the extent to which he has bargaining power, is something that we need to understand. Now, if you feel that the suppliers force is very weak, then I as a business, would be able to negotiate a better deal.

And, on the contrary, if the supplier force is very strong, then I am in a very weak position. And, might even have to end up paying more, or even get some low level of quality or service. Because, the bargaining power of the supplier is more. So, the supplier is a very critical force, in the business ecosystem.

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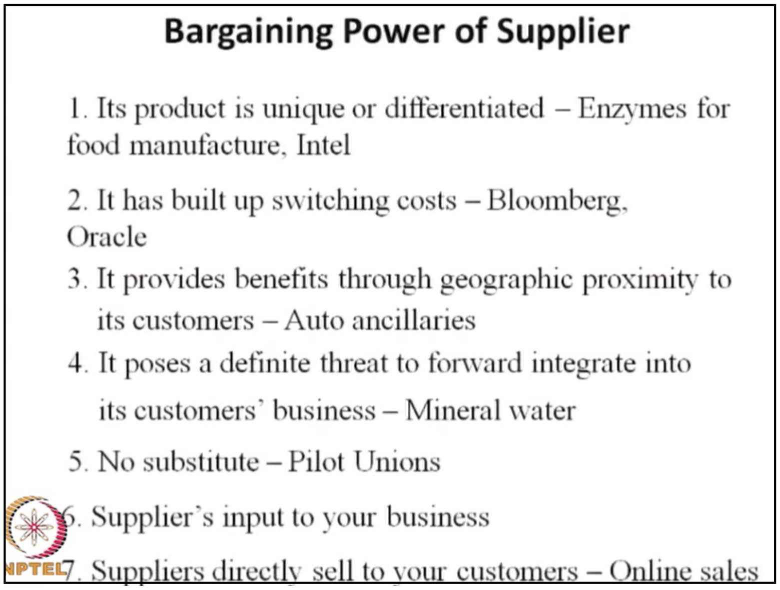

And, the supplier will have a higher bargaining power, if the input that he gives to the business, is very unique and differentiated. For example, let us say, I am in the business of some food manufacturing. And that, I am getting some enzymes from a supplier. And, my equipment, my machinery, is all tuned to process, only such type of enzymes, that the particular supplier is giving me. Then, it is very difficult for me, to change the supplier.

Because, I am not only just changing the enzyme that I am purchasing, I might even end up changing the host of machinery and equipment, that was originally suited only for a particular type of enzyme. So, a suppliers bargaining power will be more, if the input that the supplier gives to the business, is very unique or differentiated. Or probably, they are the market leaders. For example, Intel's chips. So, Intel will have, a better bargaining power, over its buyers, namely the PC or the Laptop manufacturers.

A suppliers bargaining power will also be high, when there is huge switching costs. For example, I have an ERP in place. And, let us say, I have an Oracle's ERP. So, the systems that are in place are best suited, to only execute the ERP through Oracle. And tomorrow, if I decide to switch from Oracle, to let us say, a SAP. Remember, this is a little different from the, uniqueness or differentiation example, that I gave before. The suppliers input need not be, differentiated or unique itself.

But then, it could have built in some switching costs. Which may, suppose I switch over from Oracle to SAP. Then, let us say, I have to change, a set of my IT infrastructure. Or, Bloomberg, in the stock trading business. Suppose, I switch over from Bloomberg to any other service, then I will have to change the entire support infrastructure, which originally was supporting only trading through Bloomberg system. So, the switching costs is going to be very high, then the suppliers bargaining power is more.

Or, if the supplier is very closely located, or in fact, co-located, with its customers. And, this is very typical and characteristic, especially in the automobile industry, where the auto ancillaries, the one's that who provide these auto components, are closely located to the original automobile manufacturers. This is because, they need to reduce, the lead time for delivery. So, when they are very closely located, it is getting more value for the OEM. So, the bargaining power of such customers, is also more.

Because, it takes a lot of time, if this supplier has been replaced by somebody else, who is far-off. So, there again, the bargaining power of a supplier, who is located at a very close proximity to the OEM, then there is room for higher bargaining power. Now, just as we had the threat of backward integration, in the case of buyers, there is also a great threat of forward integration. A supplier will have a higher bargaining power, if it has a definite threat to forward integrate.

Let us say, I am in the business of selling bottle water. While, I just make the bottles, I mean, the plastic bottles, and source water from outside. All that I do is, get the water, put in my bottle, just label it, and sell it, in my brand name. The suppliers bargaining power will be more, if he is able to just forward integrate. Meaning that, instead of giving the water to me, the supplier himself, you know, is able to make bottle, package it in a different brand name, and start selling it. In that case, the suppliers bargaining power is more, because he has a threat to forward integrate.

The suppliers bargaining power is definitely more, when there are no substitutes for the product. The pilot unions is a very classic example. Nobody can, you know. Let us say, they are the ones, who supply pilots to the aircraft industry. And, nobody other than a pilot can, you know, operate an aircraft. So, the bargaining power of the pilot union is very strong. And, the extent to which, this suppliers input is very critical to your business, that also determines the bargaining power of the supplier.

If the suppliers input is very critical. Let us for example say, the case of Intel, for the desktop manufacturing. Then, Intel has a better bargaining power. As against, the suppliers input, if it is not that very critical, then the bargaining power of that particular supplier is very, very low. The suppliers bargaining power will also be very high, if he can directly sell to the end customer, removing his immediate customer from the supply chain itself. A classic example is the, online sales. I mean, you go to a bookstore.

The biggest threat for physical bookstores today is that, it is not getting books from publishers, and selling it to the end customer. Nowadays, customers are able to buy, books online. So, the need for a bookstore itself, is getting diminished. So, the suppliers bargaining power will be more, if there are channels by which, direct selling can be made to customers. So, these are different ways by which, the different reasons, to understand whether, the bargaining power of the supplier is high or low.

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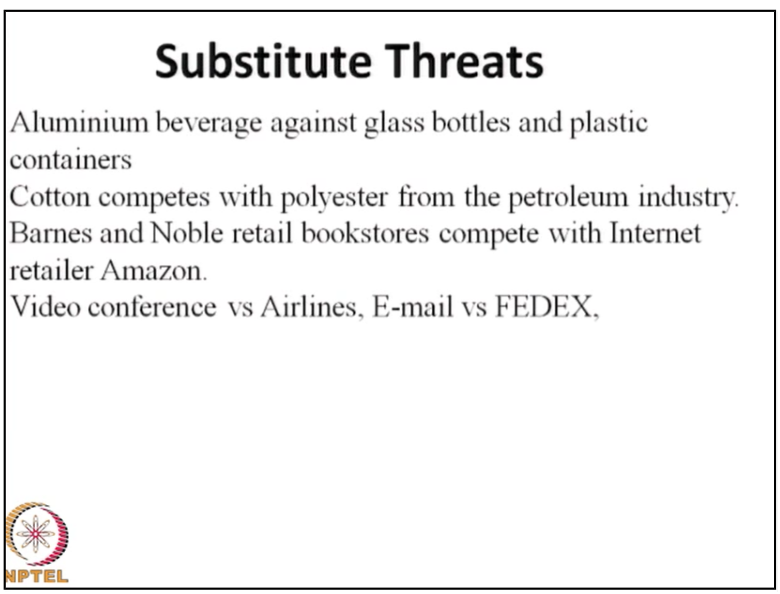

The next force is the, threat from substitutes. Some simple examples. The glass bottles and plastic containers, could be replaced by aluminium. And, this is a big threat for the glass bottling industry. Let us say, they are the ones, who supply to the beverage industry. Or, cotton nowadays, competes with polyester, for the petroleum industry. The Barnes and Noble, the same example, that I gave before. A Higginbotham's Retail Bookstore competes with, the internet retailer Amazon. Or, video conferencing today, is a big threat, for the airlines business. E-mail is a big threat for the postal business, or the FedEx.

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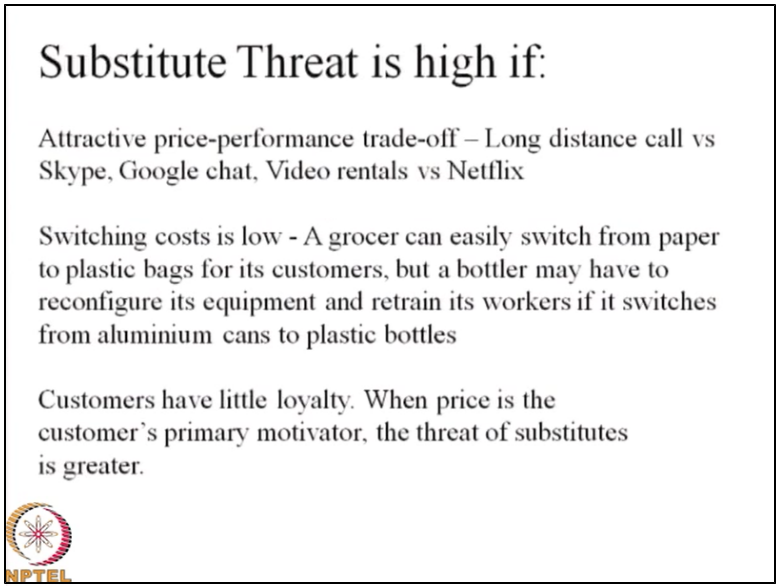

So, these are substitutes. Now, when is a substitute threat, high. Now, a substitute threat will be high, if there is an attractive price performance trade-off. Which means, I find that there is an alternate service or product, that is available at a lower price. And, moving to that alternate, I am not making a big trade-off. For example, today, a long-distance call is getting replaced by Skype. The physical video rental shops, is getting replaced by online video rentals, Netflix.

The substitutes threat is also high, if the switching cost is very low. A grocer can easily switch from, you know, a paper bag to a plastic bag, for its customers. But, that is not the case with a bottler, who may have to reconfigure his entire manufacturing process, the equipment, and re-train his workers, if it has to switch from aluminium cans to plastic bottles. So, the switching cost, as long as it is high or low, then the threat from the substitute is low or high.

And, the customer loyalty also, is a very important parameter to, gauge the threat from substitutes. Now, when the price is the primary motivator, the threat of substitute is greater because, there is no customer loyalty. Any other substitute, that is available for the same price or a lesser price, then I have every reason to move over, to a substitute product. So, the substitute threat is high or low, based on, all these parameters.

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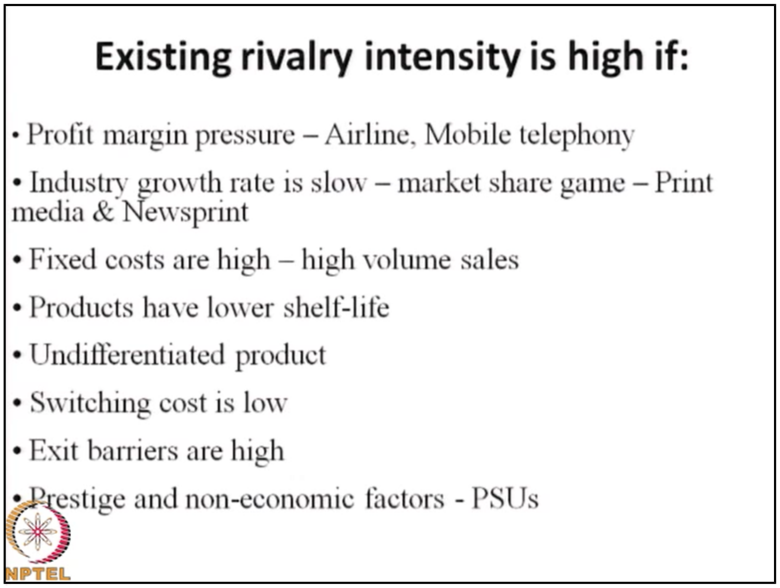

The next force is, the instance of the existing rivalry within an industry. Now, there are different sources for, that actually provides, the intensity for the rivalry. Now, let us say, we are in industry, where the growth rate is very slow. It is a matured industry. So, its fierce competition, because it is just within the same pie. Now, those who are in industry, want to get more market share. Now those are the industries where, the intensity of rivalry is very high.

If the profit margin pressure is very high, then again, the intensity of rivalry is very high. Now, let us say, if we are in an industry, where the fixed cost is very high. Which means, I need more volumes to spread the fixed costs. So, more volumes need to be sold, to recover fixed cost. And, those types of industries, the rivalry intensity will be very, very high. And, if it is an industry, where the shelf life of the product is very low, perishable goods, then there is pressure to sell it. And, in those cases, the rivalry intensity is very high

If a product itself is undifferentiated. And, since the choice, for the customers is plenty because, it is undifferentiated, there is intense rivalry, amongst those existing players. And, same is the case, when the switching cost is low. If the exit barriers are very high, again the intensity of rivalry is very high because, it is very difficult to come out of the business. And, when it is very difficult to come out of the business, you have to stay in the business. And, if it is the same for everybody in this industry, then the rivalry intensity becomes very high.

And, in some cases, for reasons of prestige and other non-economic factors, businesses stay in the industry. And, because of that, the rivalry is very intense. A classic example is, when PSU's, public sector undertakings, are just existing, just for a prestige sake, and non-economic purpose, then the rivalry is so intense because, existing other private players have to match, the price offerings that the public sector undertaking give.

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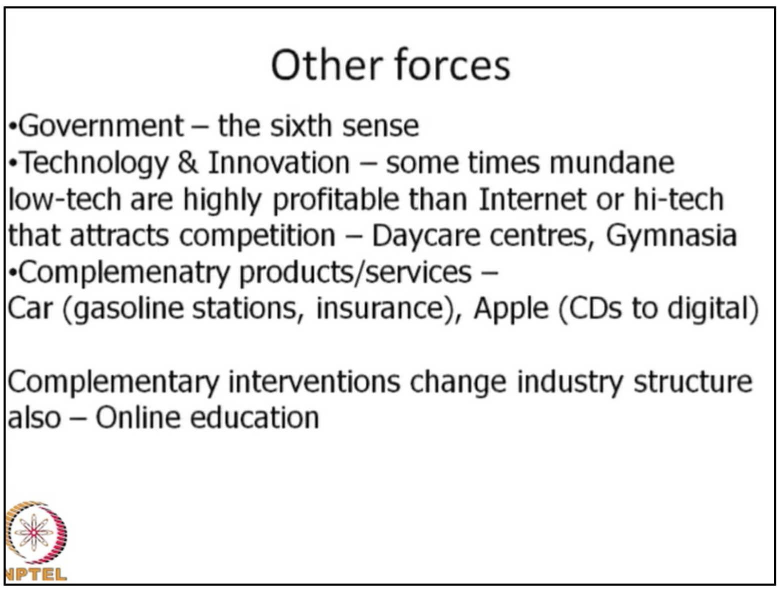

Now, other than these 5-Forces, there are also other forces, that characterise the industry structure. The government, which I usually call the sixth sense, through its regulatory framework and policy decisions, also influence the way in which, the industry is characterised. There are a lot of changes, that happen in the technology space. And, sometimes, it actually pays off to remain, low-tech. Because those, at times are the ones that are highly profitable than, internet or high-tech, because that attracts a lot of competition.

And, that is why you find, you know, Day-care centres, or Gymnasia, which are, you know, not online or high-tech, but low-tech, but extremely profitable. And, some complementary product interventions and services, also change the way in which, the industry is characterised. A classic example is the automobile industry. Today, gasoline stations. Because, the more and more cars come to the petrol stations. You find, convenient shops in the petrol station.

So, no longer is a retail petrol outlet just selling petrol, but also has a convenience store in it. So, the front end of the automobile industry, is also getting changed. Apple has changed the music industry. So, such complementary interventions, change the very industry structure itself. Another example is the online education, which is actually changing the formal education system.

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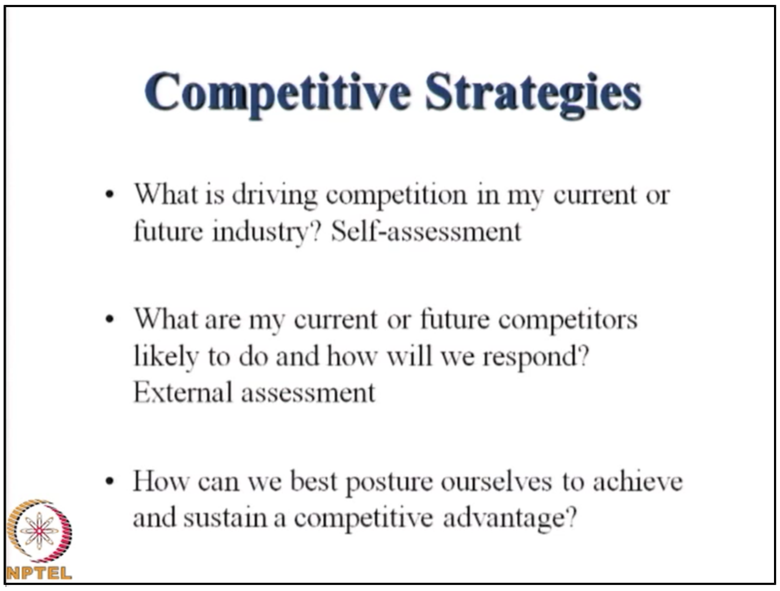

So, when we actually talk about competitive strategies, by doing an industry analysis, we would get an understanding, of what actually drives the competition, in the industry that I am currently in, or the industry in which I want to get into. And, if it is the industry that I am currently in, it is more a self-assessment exercise. And, when I do the industry analysis, I would also like to know, what are my current or future competitors would likely to do. And, how I need to respond. So, it is more an external assessment. And, by doing this, how can I position myself, to sustain a competitive advantage

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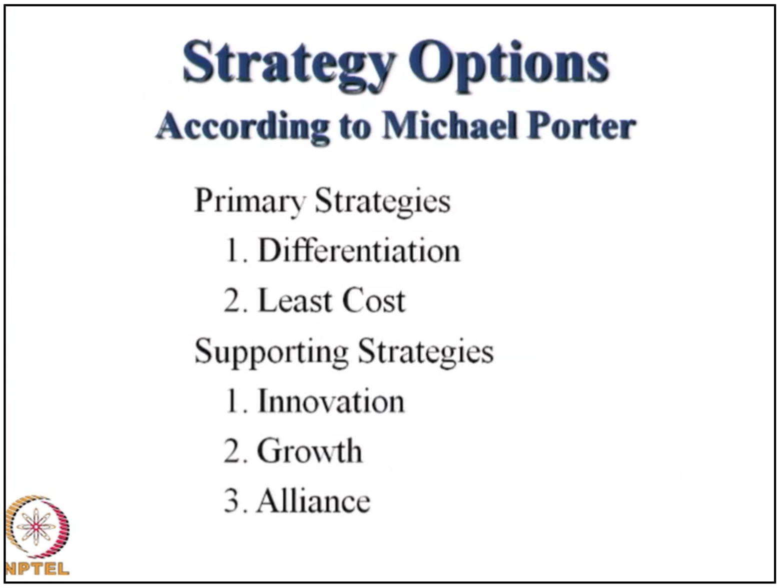

So, the primary strategies as I said before, is differentiation by creating a unique value, or provide the same comparable value at, least cost. And, how do you do this? Through, innovation, growth, alliance, there may be a lot of support strategies, to do that. Now, this class for you is to basically understand that, any industry is characterised by a set of 5-Forces. And, if you are part of the industry, then you will have to make a self-assessment, to see the extent to which, you are influenced by each of these forces. Whether, you are positively influenced, or negatively influenced.

Or, if you want to enter into a new industry, you can also look at the industry from an outside perspective, to understand the characteristic of the industry. Now, this is very useful because, it is the characteristic of the industry, which actually measures the attractiveness, which is actually a good measure of the attractiveness of the industry. The way in which, the industry structured, is a good measure of the attractiveness of the industry, both from, somebody who wants to enter the industry, or somebody who wants to make a self-assessment being, within the industry.

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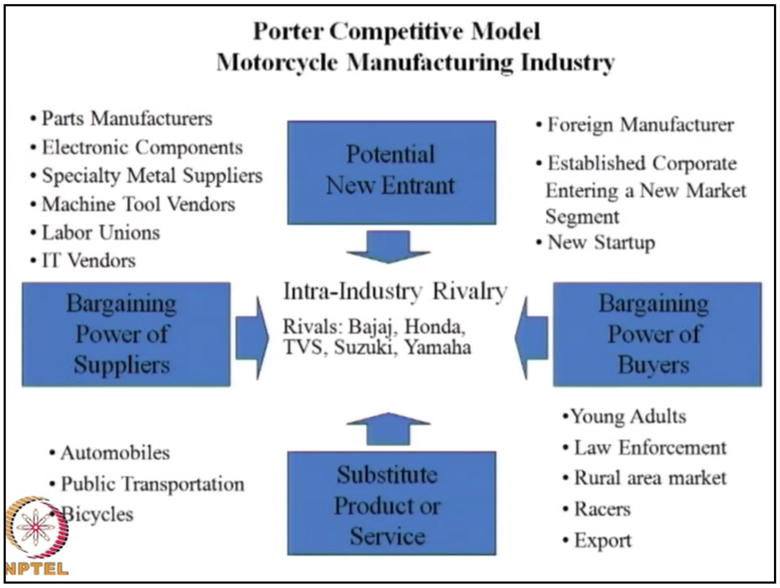

So, I just leave the class with, just this example, for you to make an assessment, of the two-wheeler industry. I will just give you some of those key issues, in each of these forces, for you to do an analysis, to see whether it is structurally attractive, to enter into this industry. Or, if you are somebody who is already into the industry, to see how you are relatively placed, when compared to others in the industry.

The intra industry rivalry for, and this is, let us just say, it is a two-wheeler automobile industry. You know, the intra industry rivalry is, because of Bajaj, TVS, Suzuki, Yamaha, Honda. So, host of such two-wheeler automobile manufacturers. Now, the potential new entrant into this business could be, a foreign manufacturer, or could be an established Indian business house, that wants to enter into a new market segment, or could be a new start-up, a new Indian start-up itself.

The bargaining power of buyers. The buyers are the young adults. Could be the government, through its law enforcement agencies. Could be the rural area market for mopeds, racers. Could also be buyers outside India. So, it is an export market. The suppliers are the auto component suppliers, part manufacturers, electronic components, speciality metal suppliers, machine tool renders, labour unions, IT vendors. So, these are all the suppliers.

The substitute for this is probably, another four-wheeler, or public transportation, or bicycles. Now, let us say, these are the different ingredients, for each of these force. What you should be doing is to see, how each of these force is influencing, an existing player in the industry. For example, this industry is a capitally intensive industry. And suppose, I am already in this industry, how much is the threat perception, from a new entrant.

Is it easy for a new entrant, to get into this business? And, since it is a capitally intensive business, and economies of scale is very large, to a certain extent, I can say that, the potential threat from a new entrant is minimum. I am not ruling it out because, anybody can enter into a business, however capital intensive it is, as long as there is enough growth potential. But, since it is capitally intensive, it takes a little time for them to enter. And, by the time, businesses already in this industry will try to, strategize their other alternate options.

But then, if you are able to provide some structure of this form, by identifying five critical forces, the threat from new entrant, the suppliers, the buyers, the substitutes, and the intra-industry rivalry, there is some discipline, by which you are able to estimate, the structural attractiveness of the industry, so that you are able to assess, the relative position of your own firm within the industry, or if you are somebody wants to enter into the industry, you would able to come to a conclusion, whether this industry structurally attractive or not.

So, it is only for this very broad purpose, this Porter's 5-Forces Industry Analysis is so popular, that many of us use it, to measure the structural attractiveness of the industry. So, when we meet next, we will probably start with other models, that are used for various other analysis purposes, both internal, as well as external. The other models could be the, BCG Matrix, the PEST Analysis, SWOT Analysis, the Balanced Scorecard. So, various other different models, that are used for different purposes, for both, an internal analysis, and an external analysis. Thank you.