

Introduction

This video is the first in a two-part series on industry analysis. In this video we introduce the industry analysis framework and in the next video we show how to use the framework to generate strategic insights that can guide strategic decisions.

Michael Porter's industry analysis helps us analyze the competitive forces that shape industry profitability. A traditional industry analysis helps us to consider the full set of players in a competitive environment that might reduce industry profitability and, therefore, threaten the success of companies in that industry. The purpose of this video is to introduce you to these different players and show you how to thoughtfully evaluate the extent to which they threaten the profitability of an industry.

Industry Analysis

First of all, what is an industry? Different people use the term "industry" in different ways. For our purposes, an industry represents a set of companies that do the same jobs for customers in essentially the same ways. We can think of this in terms of drawing a circle and then deciding who belongs in the circle and who belongs outside of the circle. So, for example, customers hire companies in the online media streaming industry to deliver media content to them on their own devices wherever they may be. As of 2019 many companies such as Hulu, Netflix, Amazon, and many others, do this job for customers. They are the competitors in this industry.

We might also draw different circles for different related industries. Our online streaming companies need to acquire content to sell, and so they purchase content from suppliers. The suppliers, in this case, are companies like Disney and Fox who produce movies and shows that consumers want to watch. We might draw a circle and put these content production companies in an industry. These are the suppliers to our online streaming industry.

Companies that do different jobs for customers or that do similar jobs in different ways belong outside of the circle. So, for example, customers hire movie theaters to deliver media content on the big screen. As of 2019 many companies such as Cinemark, AMC, Cineplex Odeon, and many others, do this job for customers. They are competitors in a *different* industry because they do a similar job of delivering media but in a fundamentally different way. We might draw another circle for this different industry.

When we focus on one specific industry, we can then identify the direct exchange partners: the industry's buyers and suppliers. Companies in our industry purchase products and services from their suppliers, then transform those products and services into new products and services that they sell to our industry's buyers. In most industries the majority of the value that flows into the industry comes through the buyers. Buyers take money from their wallets and give it to companies in your industry in exchange for products and services.

The traditional industry analysis tools help us to assess the average profitability of an industry rather than the profitability of any individual company within the industry. We do not, for example, do an industry analysis for Netflix, but we might do an industry analysis for the online streaming industry. We might imagine reaching into the circle and pulling out an average competitor and asking, “based on our industry analysis, how profitable is this *average* competitor likely to be?”

Traditional industry analysis focuses on five forces that shape the industry: rivalry, buyer power, supplier power, threat of entrants and threat of substitutes. Recently scholars have suggested a sixth force: complements. We will discuss all six.

Rivalry

The first force is *rivalry*, which captures the extent to which the nature of competition between competitors enhances or destroys industry profitability. Companies may compete by consistently undercutting each other on prices in a price war, or they may compete by offering differentiated products and services for consistently high prices. Industries typically have higher rivalry, and higher threats to average profits, when they are highly fragmented with many competitors, when there is a high level of product standardization, when industry growth rate is low, when there is production over-capacity, when companies have high fixed costs, and when there are other high exit barriers. When it is very costly for companies to exit the industry, they fight fiercely to stay alive in the industry and may be willing to do so in ways that hurt all companies, including themselves. We often observe price wars between fast food chains such as Wendy’s and McDonalds when they try to compete on price for the bargain shopping customer. In contrast, we rarely observe price-based competition in the fast-casual dining segment where companies like Chipotle and Five Guys tend to compete on differentiated food offerings.

Entrants

The second force is the *threat of entrants*, which captures the extent to which the entry of new companies into the industry enhances or destroys industry profitability. Essentially, we want to know how difficult it is for a new entrant to establish itself in the industry and capture market share. Industries have higher threat of entrants, and higher threats to average profits, when they have low scale economies, when they have low capital costs of entry, when brand awareness is less important, when buyers have low switching costs, when there are few regulations, and when there are other high entry barriers. When it is very low cost for companies to enter the industry then new entrants come in and fight to gain market share. It tends to be very easy to open a small local restaurant, for example, which tends to keep dining prices and overall margins quite low.

Buyer power

The third force is *buyer power*, which captures the extent to which customers have power to negotiate for more value and/or lower prices. Buyers tend to have more power when there are fewer buyers than companies in the industry, when they have low switching costs, when they can easily backward

integrate and when they are highly price sensitive. When buyers have power, they can use that power to demand better products and services and/or lower prices. Consider, for example, the US corn farming industry which had over 300,000 independently owned farms in 2019 but only a few major buyers. Buyers like large processed foods companies have significant power because each individual farm needs the buyer much more than the buyer needs any individual farm.

Supplier power

The fourth force is *supplier power*, which captures the extent to which suppliers have power to negotiate for higher prices from companies in our industry. This is exactly the same logic as buyer power. Suppliers tend to have more power when there are fewer suppliers than competitors in the industry, when it is costly for companies in the industry to switch away from suppliers' products and services, and when suppliers can easily forward integrate. Consider, for example, the personal computer industry during much of the 1990s and early 2000s. Every PC company needed to purchase a microprocessor, and the microprocessor industry was dominated by Intel. Thus, Intel could force PC makers to put their "intel inside" sticker on every PC they sold with an Intel chip inside. Intel could essentially charge whatever it wanted to the PC makers because it had so much supplier power relative to the PC industry.

Substitutes

The fifth force is threat of substitutes, which captures the extent to which there are other companies that do the same job as the companies in your industry but in different ways. The auto industry, for example, does the job of giving you a vehicle to get you from point A to point B, among other jobs. But, public transportation, a ride sharing service, a bicycle, a scooter, and so forth, might also get you from point A to point B. These options do the same core job, but in different ways. Thus, these represent substitutes to the auto industry. The threat of substitutes is higher when customers are highly aware of these substitutes, when they are highly available, when they are low priced, when their performance is high, and when customer switching costs are low.

Complements

The sixth force is existence of complements, which captures the extent to which there are other products and services that increase demand for the job customers hire your industry to do. If you are in the hot dog bun industry, then hot dogs are important complements. If something happens that drastically increases (or decreases) consumption of hot dogs, then demand for your hot dog buns will change accordingly. Complements enhance industry profits when customers perceive higher value when consuming your products in a bundle, when compliments are available at attractive prices, and when the performance of compliments is high.

How these forces affect the industry

Now that you know what the six forces are, let's take a moment to clarify exactly how and why these forces affect industry profits. First remember that all of the value, or revenues, enters the industry from

customers. Customers put money into the industry in exchange for its products and services. But how much money each customer pays for each product depends on the relative bargaining power of the buyers and competitors in the industry. Powerful buyers can negotiate for lower prices, which then reduce the total cash flows into the industry.

On the other side the industry has to pay its suppliers for the goods and services it needs. Again, powerful supplier can bargain for higher prices for what they provide to our industry. The higher the prices they charge then the more cash they drain from the industry. Thus, powerful buyers can choke down the flow of cash into the industry through bargaining for lower prices and powerful suppliers can increase the flow of cash OUT of the industry through bargaining for higher prices. High inflow but low outflow fills the industry with cash, while low inflow but high outflow quickly drains the industry of cash. We can think of buyer power and supplier power as a pair of forces because they both affect the flow of cash into and out of the industry.

Complements and substitutes affect industry profits in a slightly different way. They affect how many buyers come to THIS industry as opposed to any other industry that could meet their needs. Substitutes peel some of our buyers away and bring their cash to other industries, while complements attract more customers to our industry. Thus, while buyer and supplier power affect the price per unit inflow and outflow, complements and substitutes affect the total number of buyers feeding cash into our industry. We can think of complements and substitutes as a pair of forces because they both impact the total number of buyers who come to our industry.

Rivalry and threat of entrants affect industry profits because they determine how aggressively each company needs to fight for its share of the cash. If entry barriers are low, then new companies enter our industry and claim some of the available revenues. If exit barriers are high, then existing companies fight very aggressively to keep their share of the cash. If they fight for share by dropping prices, then they are choking down the inflows by allowing buyers to pay less for our industry's products and services. We can think of rivalry and threat of entrants as a pair of forces because both affect how aggressively existing competitors fight with each other for market share.

Conclusion

Hopefully you can see that there are many parties that can affect the profitability of an industry and, therefore, the profitability of companies within an industry. Thus, industry analysis gives you a framework to examine the overall profitability of an industry in order to then help you understand what company level decisions to make in order to increase your performance within your industry.

The second video in this series we will illustrate how to use the industry analysis framework to generate useful insights for your company.