

Introduction

- Porter's industry analysis studies the competitive forces that shape industry profitability.
- Here we introduce the different set of players in a competitive environment and show how to evaluate the extent to which they threaten the profitability of an industry.

Industry Analysis

- An industry is a set of companies doing the same job in the same ways.
- It's like drawing a circle and deciding who belongs inside and outside of the circle.
- In most industries, most of the value that flows into the industry comes through the buyers.
- Traditional industry analysis assesses the average profitability of an industry rather than the profitability of a specific company within the industry, i.e. there is not an industry analysis for Netflix, but there is one for the online streaming industry.
- Traditional industry analysis includes five forces: rivalry, buyer power, supplier power, threat of entrants and threat of substitutes. A sixth one, complements, has been suggested by scholars. We will discuss all six.

Rivalry

- *Rivalry* captures how competitors enhances or destroy industry profitability.
- Companies may compete by undercutting each other on prices, or by offering differentiated products and services for high prices.
- Industries have higher rivalry when:
 - They are highly fragmented with many competitors.
 - There is a high level of product standardization.
 - Industry growth rate is low.
 - There is production over-capacity.
 - Companies have high fixed costs.
 - It is costly to exit the industry, companies may fight to stay alive and be willing to hurt everyone, including themselves.
- We often observe price wars between fast food chains such as Wendy's and McDonald's.
- But we rarely observe price-based competition in the fast-casual dining segment where companies like Chipotle and Five Guys compete on differentiated food offerings.

Entrants

- *The threat of entrants* captures how the entry of new companies enhances or destroys profitability.
- How difficult is it for a new entrant to establish itself and capture market share?
- Industries have higher threat of entrants when:
 - They have low scale economies.
 - They have low capital costs of entry.

- Brand awareness is less important.
 - Buyers have low switching costs.
 - There are few regulations.
- It is usually easy to open a small local restaurant, for example, which keeps dining prices and overall margins quite low.

Buyer power

- *Buyer power* captures customers' 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.
 - They have low switching costs.
 - They can easily backward integrate.
 - They are highly price sensitive.
- When buyers have power, they can demand better products and services and/or lower prices. Consider the US corn farming industry, with over 300,000 independently owned farms in 2019 but few major buyers. Buyers such as large processed foods companies have significant power because each farm needs the buyer much more than the buyer needs any individual farm.

Supplier power

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

Substitutes

- The *threat of substitutes* captures whether other companies do the same job as those in your industry in different ways.
- Example: the auto industry gives you a vehicle to get you from point A to point B:
 - But public transportation, ride sharing services, a bicycle, a scooter, etc., also get you from point A to point B. They do the same core job in different ways.
- The threat of substitutes is higher when:
 - Customers are highly aware of these substitutes.
 - Substitutes are highly available.
 - Substitutes are low priced.
 - Substitutes' performance is high.
 - Customer switching costs are low.

Complements

- The *existence of complements* captures whether other products or services increase demand for the job customers hire your industry to do.
- For the hot dog bun industry, hot dogs are important complements. If something drastically increases/decreases consumption of hot dogs, demand for hot dog buns will change accordingly.
- Complements enhance industry profits when:
 - Customers perceive higher value when consuming your products in a bundle.
 - Complements are available at attractive prices.
 - The performance of complements is high.

How these forces affect the industry

- Customers:
 - All the value, or revenues, enters the industry from customers.
 - They put money into the industry in exchange for products/services.
 - How much customers pay depends on the bargaining power between buyers and competitors.
 - Powerful buyers can negotiate for lower prices, reducing the total cash flows into the industry.
- Suppliers:
 - On the other side, the industry must pay suppliers for the goods and services it needs.
 - Again, powerful suppliers can bargain for higher prices for what they provide to us.
 - The higher prices they charge, the more cash they drain from the industry.
- Complements and substitutes:
 - Substitutes peel buyers away, complements attract customers to our industry.
 - Complements and substitutes affect the total number of buyers feeding cash into our industry.
- Rivalry and threat of entrants:
 - Affect industry profits by determining how aggressively each company needs to fight for its share of the cash.
 - If entry barriers are low, new companies enter our industry and claim some of the available revenues.
 - If exit barriers are high, existing companies fight to keep their share of the cash.
 - If rivals or entrants drop prices, they choke down the inflows by letting buyers pay less for our industry's products and services.

Conclusion

- Many parties affect the profitability of an industry and of the companies within it.
- Industry analysis examines the overall profitability of an industry to then help you understand what company level decisions to make to increase your performance within your industry.
- The second video shows how to use industry analysis to generate insights for your company.