CHAPTER 2 – MANAGING INDUSTRY COMPETITION

CHAPTER OUTLINE

1. OPENING CASE: *Emerging Markets: Competing in the Indian Retail Industry*

a. India has the most retail outlets in the world

b. The retail industry is the second-largest job provider in India

c. The retail industry accounts for 10 per cent of India's GDP

d. The retail outlets are divided into the "unorganized" and "organized" sectors
   1) Unorganized sector
      (a) Constitutes 95 per cent of the total retail market
      (b) Comprises mostly of small mom-and-pop type stores
      (c) Has more competition compared to the organized sector
      (d) Customers are price-sensitive and shop in small quantities
   2) Organized sector
      (a) Constitutes 5 per cent of the total retail market
      (b) Comprises of modern supermarkets and chain stores
      (c) Competition is scarce – but this is changing

e. Farmers have little bargaining power

f. Prices of products get marked up as it passes through middlemen

g. FDI in multi-brand stores (such as supermarkets) was banned

h. Foreign firms are now allowed to take up to 51% equity in single-brand shops that sell their own products

i. Possible benefits of FDI in the Indian retail industry
   (a) Consumers would benefit from increased competition
   (b) Farmers would gain from greater investment in the supply chain
   (c) Can greatly decrease spoilage of products by investing in a more efficient supply chain

j. To attract farmers, foreign retailers would have to offer higher prices

k. Recent phenomenon
   1) Foreign entrants like Wal-Mart and Carrefour are trying to enter the Indian retail sector
   2) Plans to open up FDI in retail had to be suspended due to political pressure

2. DEFINING INDUSTRY COMPETITION

a. Industry – group of firms producing goods and/or services that are similar to each other

b. Theories of industry competition
   1) Perfect competition:
      (a) Price set by the market
      (b) All firms are price takers
      (c) Entry and exit are fairly easy

(d) Rarely observed in real world

2) Industrial organization (IO) economics model - structure-conduct-performance (SCP) model
   (a) Structure refers to the structural attributes of an industry (such as the costs of entry/exit)
   (b) Conduct is firm actions (such as product differentiation)
   (c) Performance is the result of firm conduct in response to industry structure

c. The industrial organization (IO) suggests that industry structure determines firm conduct (or strategy), which, in turn, determines firm performance

d. The Industrial organization (IO) help policymakers better understand how firms compete in order to properly regulate them

e. Industries can be divided according to the number of firms
   1) Monopoly - from thousands of small firms in perfect competition to only one firm
   2) Oligopoly - very few firms competing
   3) Duopoly - only two competitors

f. Monopolist firms have opportunity to earn above-average returns

g. IO economists are concerned with minimization of above-average profits

h. Strategists of profit-maximizing firms have used the SCP model to earn above-average returns

3. THE FIVE FORCES FRAMEWORK

a. From Economics to Strategy
   1) 1980 – Michael Porter translated and extended the Structure-Conduct-Performance (SCP) model of IO Economics to strategic management
   2) Key proposition – firm performance depends on the degree of competitiveness of the five forces within an industry

b. First force: Intensity of Rivalry Among Competitors

   1) Key indicators of intense rivalry – threatens firms by reducing profits
      (a) Frequent price wars
      (b) Proliferation of new products
      (c) Intense advertising campaigns
      (d) High cost competitive actions and reactions
   2) Conditions that lead to intense rivalry
      (a) Number of competitors
      (b) Similarity of firms in terms of size, market influence and product offerings
      (c) Products are big ticket items and purchased infrequently – makes it hard for one firm to dominate
      (d) New capacity must be added in large increments – creates over capacity which leads to price cutting
      (e) Slow industry growth or decline in demand
      (f) High exit costs – investment in specialized assets may prevent exit

c. Second force: Threat of Potential Entry
   1) Incumbents create entry barriers to keep new entrants out
      (a) Scale-based low cost advantages
         (i) Economies of scale
         (ii) Experience curves
      (b) Non-scale based low cost advantages
         (i) Proprietary technology

(ii) Know-how
(iii) Favorable access to raw materials and distribution channels
(iv) Favorable locations
(c) Product proliferation to leave little unmet demand
(d) Product differentiation – uniqueness of products that adds value for customers
(i) Brand identification
(ii) Customer loyalty
(i) Substantial switching costs
(ii) Network externalities
(iii) Possible retaliation by incumbents – made possible by excess capacity
(e) Government policy and regulation

d. Third force: Bargaining Power of Suppliers – ability to raise prices and/or reduce quality
1) Dominance of supplier industry by a few firms
2) Suppliers provide unique, differentiated products with few or no substitutes
3) Focal firm is not an important customer
4) Willingness and ability of suppliers to integrate forward (by becoming both supplier and rival)

e. Fourth force: Bargaining Power of Buyers – ability to reduce prices and/or increase quality
1) Small number of buyers
2) Products of the industry do not produce clear cost advantages or enhance the quality of life for buyers
3) Purchase standard, undifferentiated commodity products from suppliers
4) Willingness and ability of buyers to integrate backward

f. Fifth force: Threat of Substitutes – products from different industries that satisfy customer needs being met by focal firms
1) Substitutes are superior to existing products in terms of quality or functionality
2) Low switching costs

g. Lessons from the Five Forces Framework
1) Not all industries are equal in terms of profit potential. The pharmaceutical industry is likely to remain more profitable than the airline industry
2) Strategists should evaluate the opportunities and threats underlying each competitive force to estimate the likely profit potential of the industry
3) Use the five forces model as an industry positioning tool

4. THREE GENERIC STRATEGIES – Can strengthen focal firm's position relative to the five forces

a. Cost Leadership
1) Firm's theory about how to compete successfully centers on low costs and low prices
2) Offer better value to customers
3) Target average customers for mass market – little differentiation
4) Key functional areas are manufacturing and materials management
5) High volume, low margin approach
6) Defense against five forces
(a) Charge lower prices, earn higher profits than higher cost rivals
(b) Low cost advantage is barrier to entry
(c) Reduces power of suppliers due to high volume purchased

(d) Less affected by price increases by powerful suppliers or price concessions demanded by powerful buyers
(e) Challenges substitutes to offer better utility and better prices

7) Drawbacks to cost leadership
(a) Danger of being out-competed on costs
(b) Relentless drive to cut costs might compromise value that customers desire

b. Differentiation
1) Deliver products that customers perceive to be valuable and different
2) Target customers in smaller, well-defined segments who are willing to pay premium prices
3) Low volume, high margin approach
4) Differentiated products must have unique attributes (actual or perceived) – quality, sophistication, prestige, or luxury
5) Challenge – identify attributes that are valued by customers in each market segment
6) Key functional areas are research and development (source of innovations), marketing/sales and after-sale services
7) Defense against five forces
(a) Less resemblance to rivals affords greater protection from five forces
(b) Ability to pass on suppliers' price increases to buyers
(c) Strong brand loyalty mitigates buyer power
8) Drawbacks to differentiation
(a) Difficult to sustain basis of differentiation in the long run
(b) Relentless efforts of competitors to duplicate differentiation

c. Focus
1) Serves the needs of a particular segment or niche of an industry
2) Segments can be defined by geographical market, type of customer, or product line
3) Needs of niche/segment are so unique that broad-based competitors choose not to serve them or are not able to do so
4) A focused firm is either a specialized differentiator or a specialized cost leader
5) Defends against five forces in same ways as differentiation or cost leadership

d. Lessons from the Three Generic Strategies
1) Essence – choose whether to perform activities differently than rivals or to perform different activities than competitors
2) Cost and differentiation are two fundamental strategic dimensions
3) Performance of firms that are stuck in the middle may suffer

5. DEBATES AND EXTENSIONS

a. Clear versus Blurred Boundaries of Industry
1) Sometimes it is hard to determine the exact boundaries of an industry – e.g. telecommunications.

b. Threats versus Opportunities
1) Strategic alliances are on the rise – reduce rivalry, encourage cooperation
2) Intense rivalry provides impetus to constantly improve and innovate – makes firms more competitive in domestic and international markets
3) Five forces model over-emphasizes threats and downplays opportunities

c. Five Forces versus A Sixth Force
1) Related and supporting industries (complementors) are an additional force that can impact the competitiveness of an industry

d. Stuck in the Middle versus All-Rounder
   1) If a low-cost firm has already achieved the maximum efficient scale, they must turn to differentiation to distinguish themselves from competitors
   2) Flexible manufacturing technology has enabled firms to produce differentiated products at a low cost – mass customization may become the name of the game in the future

e. Industry Rivalry versus Strategic Groups
   1) In broadly defined industries, not every company competes against every firm
   2) There are often groups of firms that compete against each other
      (a) Strategic groups in auto industry – mass market firms, luxury firms, and ultra luxury firms
   3) Strategies of firms within a strategic group tend to be similar, so does their performance
   4) Controversial issues with strategic groups
      (a) Stability of strategic groups
      (b) Mobility barriers between strategic groups
      (c) Strategic group analysis requires large quantities of objective data – how useful is it when there is a paucity of data?

f. Integration versus Outsourcing
   1) Industry-based view recommends backward or forward integration as a way to defend against the power of suppliers and buyers
   2) Integration is very expensive – so it might make sense for firms to outsource instead
   3) Integration can reduce strategic flexibility
   4) Internal suppliers often lose competitiveness – cost and quality suffer
   5) Activities that are crucial to the core business should not be outsourced
   6) Supplier relationships that are too close may introduce rigidities, including loss of flexibility
   7) In Japan suppliers may become trusted members of the *keiretsu* (interfirm network). Instead of treating suppliers as adversaries, they are treated as collaboration partners

g. Industry-versus Firm- and Institution-Specific Determinants of Performance
   1) Recent success of firms in unattractive industries suggests that there must be firm-specific resources and capabilities that determine firm performance
   2) Industry-based view ignores the impact of industry history and institutions on firm performance
   3) Strategists need to understand how institutions affect competition

h. Making Sense of the Debates
   1) Porter's five forces framework identifies relevant variables and questions to ask
   2) Other frameworks also add insight about competition and firm performance

6. THE SAVVY STRATEGIST

a. Industry-based view provides a systematic foundation for industry and competitor analysis

b. Industry-based view provides some answers to the four fundamental questions proposed in chapter one
   1) Why do firms differ?
      (a) Five forces in different industries lead to diversity in firm behavior
   2) How do firms behave?
      (a) Maximize opportunities and minimize threats presented by the five forces
   3) What determines the scope of the firm?
      (a) Examine the relative bargaining power of the focal firm compared to suppliers/buyers
      (b) Traditional view recommends integration – increases the scope of the firm

(c) Recent work cautions against integration in favor of outsourcing
    (i) Focus on core activities
    (ii) Be willing to collaborate with suppliers/buyers, as well as competitors

4) What determines the international success and failure of firms?
    (a) Industry specific characteristics (i.e. the five forces)

CHAPTER TWO - LECTURE NOTES AND TEACHING TIPS

SUMMARY OF THE OPENING CASE: ***Emerging Markets: Competing in the Indian Retail Industry***

This opening case highlights some of the recent trends in the retail market of India, and the difficulties involved for foreign entrants in entering this market due to the FDI policy adopted by India in this market.

Teaching Tip: Ask students to respond to the following case discussion questions (Possible answers are included in italics):

What are issues facing the Indian retail markets regarding FDI?

India has the world's highest density of retail outlets. It has more than 15 million outlets, compared with 900,000 in the United States, whose market (by revenue) is 13 times bigger. With a booming economy, a fast-growing middle class, and fragmented local competitors, this industry is the world's biggest untapped retail market. Not surprisingly, foreign giants such as Wal-Mart, Carrefour, Metro, and Tesco are knocking at the door trying to expand the organized sector. However, there is a catch: The door is still officially closed to foreign direct investment (FDI) in this industry. Since the post-1991 opening to FDI has brought India to the global spotlight, investing in India has become one of the top items on the corporate to-do list in many multinationals.

To attract more FDI, the government in November 2011 announced that foreign firms could now own 51% of multi-brand retailers (up from zero) and foreign firms' stake in single-brand retailers could now reach 100% (up from 51%). But a huge political brawl erupted after the announcement. Many shopkeepers, supported by middlemen, protested against the alleged onslaught of multinationals and cited the controversial "Wal-Mart effect" being debated in the United States and elsewhere. Interested in shopkeepers' votes, the government thus faced a dilemma. In December 2011, a mere two weeks after the announcement of the retail reforms, a humiliated government announced that it would suspend the reforms that would bring lower prices for consumers and better prices for farmers.

What are the possible advantages to India in letting FDI in its retail markets?

With a booming economy, a fast-growing middle class, and fragmented local competitors, the Indian retail is the world's biggest untapped retail market. Foreign giants such as Wal-Mart, Carrefour, Metro, and Tesco are trying to expand the organized sector. One of the leading arguments is that super-efficient retail operations will enhance efficiency throughout the entire supply chain. At present, about a third of fruits and vegetables spoils while in transit, a catastrophe in a country while so many go hungry. In countries with more modern retail systems, less than a tenth is lost. Until 2011, foreign firms could take up to 51% equity in single-brand shops that sell their own products, such as Nike, Nokia, and Starbucks. Foreign firms could also set up wholesale and sourcing subsidiaries that supply local mass retail partners.

Farmers would gain from greater investment in the supply chain. Currently farmers have little bargaining power. They sell to a wholesale market, which dictates prices. The wholesaler then sells the produce to another middleman, which further passes the produce to a distributor. By the time food reaches the consumer, it will have been marked up three to four times, but nearly all of that goes to various middlemen, not farmers. Easy profits provide little incentive for middlemen to enhance efficiency and invest in modern supply chain (such as cold storage), and food spoils along the way. To attract farmers,

foreign retailers would have to offer higher prices. Wal-Mart set itself a target of increasing farmer income by 20% over five years. Cost-conscious foreign retailers would then invest in modern supply chain to minimize food spoilage.

DEFINING INDUSTRY COMPETITION

Sometimes students have difficulty grasping what the concept of industry means – they confuse an individual firm with an industry and vice versa. In addition, the term "industry structure" is particularly problematic. This difficulty has been exacerbated in recent years as the boundaries that separate one industry from another have become blurred. It is good to stop and highlight these terms, explaining what they mean, and what they do not mean (e.g. do not confuse industry structure with organization structure).

Teaching Tip: Select an industry with which students are familiar and ask them to identify companies that are competing in that industry. What are some of the products and services that those companies provide that make them members of the same industry?

THE FIVE FORCES FRAMEWORK

The five forces framework forms the basis for the industry-based view of strategy. It highlights five different industry forces that can impact the profit potential of any industry and make it difficult for firms to earn above average profits. The five forces framework provides insight into the opportunities and threats underlying each competitive force and why there are industry differences in profitability.

THREE GENERIC STRATEGIES

Porter also suggested that there are three main generic strategies (i.e. theories about how to compete successfully) that companies use to strengthen their position: cost leadership, differentiation, and focus.

The author suggests a number of challenges or criticisms of the industry-based view of strategy that was presented in this chapter. Each of these debates offers some valid questions about the ability of the industry-based view to explain all performance differences among firms. For example, in cases where it is difficult to clearly identify the boundaries of an industry (e.g. broadcast television industry, or telecommunication), strategists might not be able to accurately evaluate all of the factors that influence the strength of each force of competition. Likewise, when the boundaries between firms are blurred by the use of partnerships and strategic alliances, it may be difficult to pinpoint performance difficulties that are due to industry-specific factors. In addition, when companies work together, they might be able to better defend against the five forces and reduce the negative impact of industry structure on performance. Furthermore, as more firms use outsourcing instead of vertical integration, they will have to find other ways to defend against powerful suppliers and buyers.

Teaching Tip: In order to help students understand the strategic implications of these criticisms of the industry-based view, it might be helpful to ask students to work in small groups to find specific examples that illustrate or demonstrate the aforementioned criticisms. For example:

- Identify examples of industries in which boundaries are blurred. What are the common characteristics of these industries?

Students might select the cell phone industry and suggest that the boundaries are blurring. Many cell phones now offer portable features that used to be available only in PDAs, such as email, Internet access, calendars, spreadsheet capabilities, digital cameras, games, etc.

Regardless of the examples identified by students, they should be able to find a few common characteristics, such as the fact that companies in both industries satisfy similar customer needs, and that many of the same competitors compete in both industries. Another common characteristic is that the industries share similar technologies, distribution channels, and/or research and development capabilities. Furthermore, as the boundaries between industries continue to blur, there will probably be some consolidation as firms merge in order to make better use of their collective resources and capabilities. As a matter of fact, if students are having difficulty identifying examples of industries with blurred boundaries, it might be easier to ask them to find examples of industries that share these common characteristics and then discuss whether or not the boundaries are blurring.

- Brainstorm possible advantages of strategic alliances for small and medium-sized firms. How might these advantages help defend against the five forces?

Ask the students to come up with some advantages of strategic alliances, such as the ability to pool resources and use them more effectively; the opportunity to gain access to new technology or other core competencies that one partner possesses and the other does not; the opportunity to learn from the strategic alliance partners; the ability to gain access to new customers that are served by the alliance partner; the opportunity to gain access to foreign markets and/or foreign suppliers, etc.

The use of strategic alliances can help smaller and medium-sized firms become more equal to larger competitors in terms of size and capabilities, thus minimizing the ability of those larger rivals to use price cuts or other measures to intensify rivalry and drive out the smaller firms. Alliance partners might also be able to erect barriers to entry as they join forces to create economies of scale, share proprietary technology, develop new ways to differentiate and capture favorable locations as well as access to raw materials/distribution channels. The airline code-sharing alliances are good ones to mention as examples, as they are partly an extension of the frequent flier or mileage programs, and also expand the reach of an airline such as American to places that it cannot secure routes (e.g. to East Asia, via its alliance with Hong Kong-based Cathay Pacific).

POSSIBLE ANSWERS TO CRITICAL DISCUSSION QUESTIONS

1. Why do price wars often erupt in certain industries, such as the automobile industry, but less frequently in other industries, such as the diamond industry? What can a firm do to discourage price wars or to better prepare for price wars?

   Price wars usually erupt when firms cannot easily differentiate their products from one another. As in the PC industry today, or along certain airline routes, price wars are common as most firms are not able to convince customers that their products are different from the competitors'. In addition, in a slow growing market, firms are more likely to compete for market share to emerge as one of the top two or three firms. To solve this problem, firms should not assume that their products are destined for commoditization; they may be able to add new features and functions to differentiate from lower end products. For example, Swatch was able to add fashion and a broader range of product offering to differentiate from the low-priced commodity watches that Swatch was (initially) targeted against. To better prepare for price wars, it is important to get costs down. This is not only cost cutting (which is a day by day process), but also doing other things consistent with a low cost strategy. This would include trimming the product line, minimizing product variation and customization, selling through distributors that can push the product, thus reducing promotion expenditure, and selling the products in quantity (bundling) whenever possible or feasible.

2. Compare and contrast the five forces affecting the airline industry, the fast food industry, the beauty products industry, and the pharmaceutical industry (1) on a *worldwide* basis and (2) in *your* country.

Which industry holds more promise for earning higher returns? Why?

It is useful to compare the US and Asian airline industries.

US Airlines

Entrants -- Moderate. There are a number of secondary airports in the US looking to expand and attract passenger jets to land. Easy to build a fleet by leasing planes.

Rivalry – High. This is a product that is still hard to differentiate. The frequent flier programs helped a little, but people joined multiple programs, so they are not a big edge anymore.

Suppliers – Low. Sometimes the oil suppliers cause trouble for the airlines, but they do it to everyone, and usually only temporarily. The aircraft manufacturers are not that powerful; they compete fiercely for new business. Airline labor is very powerful in the US – they regularly bid away an airline's profit in new contracts, and have driven airlines to the brink of bankruptcy.

Buyers – Moderate. Travel agents are a lot weaker today and passengers have a lot of choice and can switch, but not on all routes.

Substitute products. Low to moderate. Some substitutes possible on short routes (less than 400 km), mostly on the US east coast and along the west coast. High-speed regional trains, though planned, will not be built in the near term.

Asian Airlines

Entrants – Moderate. Asia has many new airports and some secondary ones that are almost all under capacity. Analysts except significant competition, at least for holiday travelers in Southeast Asia, and increasingly in Greater China.

Rivalry – Low. Asian airlines still have markets carved up, with collaboration with their governments. Exceptions to this are coming from Southeast Asia, in Singapore-Jahal (Malaysia), and the Philippines.

Suppliers – Low. Labor is much weaker in Asia than in the US. Labor cannot bid away all an airline's profit in a labor contract or enact stifling work rules. Travel agents a bit more powerful, but heavy competition among agents in Asia. Similar supplier issues as in the US.

Buyers – Low. Not much choice for Asian travelers. They may be able to switch, but airlines dominant their regions (e.g. Cathay and Dragon Air in Hong Kong), so they have the most convenient flights and quantities of seats by far.

Substitute products. Low. Unless one has time to travel by ship around Asia, travelers are pretty much stuck with flying.

Contrast the Pharmaceutical industry:

Entrants – Low. Only a couple of significant entrants since the 1950s, mostly on the back of a new technology. This may change with the refinement of traditional (Chinese and Indian, primarily) complementary medicines. But not in the near-medium term.

Rivalry – Low. With the exception of the few drugs treating a well-known biological mechanism drugs rarely compete directly. Easy to differentiate.

Suppliers –Mostly low, though medical research staff is expensive.

Buyers – Low, but increasing. Individual patients are weak, physicians and hospitals not price sensitive. Governments are an emerging powerful buyer, however.

Substitutes – Low. Nothing has emerged as substitutes for most drugs (e.g. food products, other therapies). This may change with traditional Chinese and Indian medicine in the medium term.

3. As a manager, is it ethical to threaten your suppliers? Your buyers?

Students answer may vary.

The ethical implications of a threat depend on the nature of the threat. Threatening while unprovoked would be ethically wrong. Also, threatening with physical violence, even when provoked, would be unethical. But here again, the nature of the threat has to be assessed. No matter what the nature of

the threat, it would have to be within legal means. One could threaten a supplier with contract revocation if the supplier's actions or intentions prove to be harmful to one's business, or for producing nonconforming goods. Similarly, a buyer can be threatened with legal action for outstanding bills, for actions resulting in spoilage of products, or not accepting conforming goods. But constantly and unnecessarily using threatening techniques with either suppliers or buyers will make it difficult for others to business with you as you would appear untrustworthy and unprofessional. All business transactions should be underlined by mutual respect and measured responses.

TOPICS FOR EXPANDED PROJECTS

1. Conduct a five forces analysis of the "business school" industry or the "higher education" industry. Identify the "strategic group" in which your home institution belongs to. Then use this analysis to explain why your home institution is doing well (or poorly) in the competition for better students, professors, donors, and ultimately rankings.

   The students should follow the outline given in #2 above for the five forces with explanation and suggestions of changing patterns in the industry. For the strategic group of the university, ask the students to identify which universities (or business schools) compete most directly with their university, and which schools may be in the general vicinity, but are obviously not in the same market for students (e.g. technical schools, community colleges, small private schools, for example). Is the student's school able to differentiate from the competitors? Do people, particularly firms and recruiters, understand the school's mission and what it does best? Where does it excel, and what does it downplay or seek to not teach?

   For example, in terms of strategic groups, the author's home institution, Ohio State University, belongs to several such groups:

   - *Big Ten – Large, flagship, state universities in states in the Midwest (e.g., Indiana, Michigan, Minnesota, Purdue, etc)*
   - *Self-defined national peer group (officially used by the university) – Big Ten + other schools "comparable in size and mission," which include Arizona State, Texas, UCLA, Washington, etc.*
   - *Regional peer group – other schools in Central Ohio (e.g., Capital, Franklin, and Ohio Universities). For instance, Ohio State directly competes with them for students in the evening MBA program.*
   - *State/public universities – This is the largest strategic group, based on ownership. One of the goals of Ohio State is become a leading public university.*

   For most schools, it is possible to identify these different, yet somewhat overlapping, strategic groups. It is useful to assess how your school competes successfully (or unsuccessfully) against these different groups of competitors.

2. "Excessive profits" coming out of monopoly, duopoly, or any kind of strong market power are targets for government investigation and prosecution (for example, Microsoft was charged by both US and EU competition authorities). Yet, strategists openly pursue above-average profits, which are argued to be "fair profits." Do you see an ethical dilemma here? Working in pairs, with one person performing the role of an antitrust official and the other acting as a firm strategist (such as Bill Gates), write two statements, each with a rebuttal, to support both sides of the argument.

   The student in the role of the antitrust official should know that antitrust is designed to preserve competition, not competitors. As long as there are viable alternatives to a product, and customers are not 'held up' by Microsoft or other very dominant players, then there is not dilemma or need for the government to intervene. The student could say that a large firm can often prevent the entry of smaller

firms into the market, thus limiting innovation, and creating a seller's market for its products. the student can also cover the issues of predatory pricing, monopoly pricing, and illegal cross-subsidization and artificial product bundling, which are more objective in terms of anti-competitive, anti-consumer practices.

The student who takes on the role of the firm strategist could argue that a firm's high profits could just reflect its technological or marketing superiority over its rivals. The firm's profits allow it to constantly improve its efficiency and its product offerings, and better serve its customers.

3. A powerful new entrant is likely to drive a lot of smaller incumbent firms out of business and their employees out of work. In the Opening Case, this is the heart of the debate on whether the Indian retail industry should be open to FDI. As a manager at Wal-Mart interested in entering India, how do you respond to the political uproar against such entry? As an Indian government official, how do you introduce the new policy to allow such entry to an angry crowd of mom-and-pop shopkeepers? Write a short paper to explain your answers.

   Student answers will vary. As the manager of Wal-Mart, should explain that India's economy is booming with a fast-growing middle class. The Indian retail is the world's biggest untapped retail market. But its retail industry is mostly unorganized with fragmented local competitors. The most pertinent issue concerning retail is spoilage of food products as a result of bad maintenance or storage facilities. At present, about a third of fruits and vegetables spoil while in transit, a catastrophe in a country where so many go hungry. In countries with more modern retail systems, less than a tenth is lost in this manner. With FDI in retail there is hope for drastic and rapid change. FDI can vastly improve the efficiency and modernity of the supply and transport industry. Farmers would gain from greater investment in the supply chain. At present, farmers have little bargaining power. They sell to a wholesale market, which dictates prices. The wholesaler then sells the produce to another middleman, which further passes the produce to a distributor. By the time food reaches the consumer, it will have been marked up three to four times, but nearly all of that goes to various middlemen, not farmers. Easy profits provide little incentive for middlemen to enhance efficiency and invest in modern supply chain (such as cold storage), and food spoils along the way. To attract farmers, foreign retailers would have to offer higher prices. Wal-Mart set itself a target of increasing farmer income by 20% over five years. Cost-conscious foreign retailers would then invest in modern supply chain to minimize food spoilage.

   As a government official, you would be aware that introducing a policy concerning such a sensitive issue would require careful study of the players involved, and the sectors that are going to be affected. You should know that mom-and-pop stores would probably be afraid that big retail chains would price out their products as a result of their economies of scale. However, you can point out that large retailers lack the local insight that many smaller retailers have into the needs of people in their immediate vicinity. Mom-and-pop stores are also the go-to places for urgent and impulse purchases, for which people would not want to travel to a large retailer. You could explain to the store owners that they will still fulfill an important customer need. Though they may not be able to compete with large retailers on price, the advantages of location and time savings will give them their own niche in customer purchases. The introduction of foreign firms could also improve the overall efficiency of the Indian retail sector, and minimize waste, which will benefit all retailers in the long run.

CLOSING CASE*: EMERGING MARKETS: HIGH FASHION FIGHTS RECESSION*

OVERVIEW

Pumping out fancy clothing, handbags, jewelry, perfumes, and watches, the high end of the fashion industry—otherwise known as the luxury goods industry—had a challenging time in the Great Recession. In 2008, banks were falling left and right, unemployment rates sky high, and consumer confidence at an all-time low. In 2009, total luxury goods industry sales fell by 20%.

The high-end fashion industry was dominated by the Big Three: LVMH (with more than 50 brands such as Louis Vuitton handbags, Moët Hennessy liquor, Christian Dior cosmetics, TAG Heuer watches, and Bulgari jewelry), Gucci Group (with nine brands such as Gucci handbags, Yves Saint Laurent clothing, and Sergio Rossi shoes), and Burberry (famous for raincoats and handbags). Next were a number of more specialized players such as king of menswear Ermenegildo Zegna and queen of womenswear Christian Lacroix. By definition, high fashion means high prices. An informal code of conduct (or norm) permeates the industry: no discount, no coupons, no price wars please—in theory at least. But during the Great Recession many firms cut prices—but quietly. The only firm that stood rock solid was the industry leader LVMH, which claimed that it never puts its products on sales at a discount.

The bloodbath in the Great Recession forced the weaker players such as Christian Lacroix and Escada to file for bankruptcy. But it made stronger players such as LVMH even more formidable. They benefitted from an established pattern in high fashion: the flight to quality. In other words, when people have less money, they spend it on the best. As the recession became worse, many middle-class customers in economically depressed, developed economies began to hunt for value instead of triviality and showing off.

In addition to managing interfirm rivalry, how to manage the fickle and capricious customers was tricky. As the recession became worse, many middle-class customers in economically depressed, developed economies began to hunt for value instead of triviality and showing off. Emerging markets, especially China, offered luxury goods firms the best hope while the rest of the world was bleak. Since 2008, while global sales declined, Chinese consumption (both at home and traveling) had been growing between 20% and 30%. In 2009, China surpassed the United States to become the world's second-largest market. In 2011, China rocketed ahead of Japan for the first time as the world's champion consumer of luxury goods—splashing $12.6 billion to command a 28% global market share.

POSSIBLE ANSWERS TO CASE DISCUSSION QUESTIONS

1. Using the Five Forces framework, how would you characterize the competition in the luxury goods industry?

The high-end fashion industry was dominated by the Big Three: LVMH, Gucci Group, and Burberry. Next were a number of more specialized players such as king of menswear Ermenegildo Zegna and queen of womenswear Christian Lacroix. As these firms were relatively differentiated, the degree of rivalry between firms is unlikely to be very high. As practices like discounting and price wars were frowned upon during pre-recession times, competition was likely to have been understated, and not overt. However, during the Great Recession, when some luxury goods firms began discounting, competition may have increased. In developed countries, the threat of entry of potential entry of new competitors was low during the recession, while the threat of entry was high in Eurasian countries like China, where the market for luxury goods expanded.

2. How much bargaining power did consumers as buyers have during the Great Recession?

The Great Recession saw the appeal of traditional European markets for high fashion wane, as Eurasian countries which were relatively unaffected by the recession gained importance for fashion houses. Although the seriously rich in developed countries were not affected by the Great Recession, their number remained small. Luxury goods firms turned to China and other Asian countries to encourage market growth based on aspirational customer in the middle-class segments. Therefore, while the bargaining power of consumers in the developed countries was probably high, due to the small number of buyers, the bargaining power of consumers in the developing world was probably much lower, as there was a large market for luxury products in this region.

3. Why was discounting looked down upon by industry peers, all of which were differentiated or focus competitors?

High fashion relies on its high process to maintain its image and demand. The informal code of conduct that governs the high fashion industry dictates no discount, no coupons, and no price wars between competitors. Discounting, a strategy that is frequently used in the low-end fashion industry, is generally viewed as dangerous and poisonous in high fashion, not only to the occasional firm that uses it, but also to the image and margin of the whole world of high fashion. During the Great Recession, for instance, many firms cut prices—but did so quietly. At Tiffany jewelry stores, salespeople advised customers about diamond ring price reductions, but otherwise there was no publicity. Gucci and Richemont offloaded their excess inventory to discount websites. The only firm that stood rock solid was the industry leader LVMH, which claimed that it never puts its products on sales at a discount. When the going gets tough, it destroys stock instead. This strategy benefitted LMVH during the recession, when cash-strapped buyers, following a well-established pattern in high fashion, opted to spend money on a few, classic items of high quality, rather than many lower-priced pieces. LMVH's avoidance of discounts actually gained market share for the company during the recession, and sales grew from $24 billion in 2008 to $29 billion in 2011.

4. What would be the likely challenges in emerging markets for luxury goods firms?

Some of the issues that could arise for luxury firms entering emerging markets are issues with costs involved in transporting the luxury items into emerging market countries, restrictive traffic rights, high import taxes and other challenges with regional governments that can complicate logistics. Adopting or investing in a stronger supply and distribution channels would be important. Also, institutional factors, and possible the liability of its foreignness will have to be strongly considered if the firm plans to function smoothly in an emerging market. Emerging markets, especially China, offer luxury goods firms the best hope while the rest of the world recovers from the recession. As many firms want to enter these markets, competition will probably be high, and the luxury goods companies will have to operate differently from their operations in the developed markets. As cultures and buying patterns might differ across countries, firms would need to develop a thorough understanding of their customers in order to succeed in emerging markets.