Chapter 2

INDUSTRY ANALYSIS

INTRODUCTION

This chapter introduces students to external environmental analysis and a range of concepts, tools and frameworks including PESTEL analysis, Porter's five forces of competition analysis, segmentation analysis, and key success factors. These tools and techniques are widely disseminated within the field of business and management so strategy instructors (whose modules often come towards the end of students' programmes of studies) may find that their students are already familiar with parts of this material and feel that they 'have heard all this before'. Unfortunately, more often than not, students' knowledge of external analysis proves to be somewhat superficial and these tools and techniques are applied in very mechanical, and not particularly insightful, ways. The challenge for the instructor is maintaining students' interest whilst, at the same time, conveying the importance of rigorous and detailed analysis. We find that the best way to do this is to focus on practice, not only through the liberal use of practical examples but also by encouraging students to think critically about the challenges of undertaking meaningful external analysis.

Our goals in this session are to ensure that students:

- are familiar with key frameworks used to analyze organizations' external environments and gain a sound understanding of how the structural characteriztics of an industry influence competition and profitability;
- are able to use evidence on structural trends within industries to forecast likely changes in competition and industry attractiveness and to consider the implications of such changes for organizations' future strategies;
- understand the value and challenges of undertaking external analysis and are able to provide a critique of PESTEL analysis, Porter's five forces of competition framework; and the competitive positioning plot; and
- are able to analyze competition and customer requirements in order to identify 'key success factors'.

LECTURE/INSTRUCTOR-LED ACTIVITY

The number of sessions the instructor devotes to this topic area needs to be tailored to suit his or her class. If time permits two class sessions may be used to develop this topic – the first outlining the key frameworks (PESTEL, Porter's five forces model) and how these models are applied in a practical business context; the second exploring extensions to, and limitations of, the frameworks. When the delivery pattern is more intensive and face-to-face, contact time is at a premium; instructors may prefer to ask students to read the first part of Chapter 2 and to watch a short podcast outlining the key frameworks. The taught class then focuses on the value derived from utilizing these frameworks, the challenges that arise when applying these frameworks in practice, and the academic critique of industry analysis.

A good starting point for a lecture is PPT slide 16. (Feel free to reorganize the sides to suit your needs) The instructor poses the question, why does profitability vary so significantly between industries? Why, for example has the median return on equity in 2013 been 18.5% for firms operating in the health care industry but only 5.7% in the utility industry? PPT slide 17 can be used to guide the discussion. Presented with these questions students often jump to conclusions or produce glib answers, but we emphasize the need for careful diagnosis

and a deep understanding of the changes that have taken place in the external environment in relation to the underlying structural characteriztics of industries.

PPT slides 3–12 enable you to take an industry where there are significant changes in overall performance of firms over time. Mobile phones, like personal computers or even horse racing, have had their margins squeezed and overall industry profitability has fallen over time.

The class proceeds by taking students through standard frameworks such as PESTEL and Porter's 5 forces. We find it useful to outline frameworks in relation to a selected industry example. Chapter 2 takes the mobile handset industry as the illustrative case but plenty of other examples exist that are equally likely to capture the students imagination (or relate to the student's selected field of study), for example, the video games industry, the DVD rental business, food retailing, or even dredging. Industries that are being transformed by technology are often appealing to students, for example, the music industry or book publishing, and provide a fascinating site for study. But because the value chains of these industries are unbundling and re-bundling, students can find these kinds of examples confusing. From experience, we find it is better to start with a relatively straightforward example and build in complexity once the fundamentals have been mastered.

We highlight the way in which the analysis can be applied in terms of forecasting industry profitability, positioning the organization, and influencing industry structure to the business' advantage. Students are then introduced to some of the challenges of applying these frameworks in practice as well as the academic debate surrounding industry analysis.

TUTORIAL/STUDENT-LED ACTIVITY

The emphasis in both Chapter 2 and Chapter 3 (Resources and Capabilities) is on the challenge of undertaking this kind of analysis in practice, so tutorial activities designed around case material or group work investigating selected companies work best.

The closing case to Chapter 2 centres on Scotiabank and the banking industry. Most students have some kind of appreciation of the banking industry and they will be able to draw on their own experiences as well as the case material when answering the case questions. The suggested answers also contain some tips on where students might find additional material.

SUGGESTED ANSWERS TO SELF-STUDY QUESTIONS

1. Over the five-year period of 2008–2013, BlackBerry's share price fell from over $140.00 to less than $8.00 per share. Use PESTEL analysis and Porter's five forces of competition framework to evaluate the decline of BlackBerry (formerly known as RIM) in the market over time and to explain the forces that drive competition in this industry.

PESTEL Analysis

<u>Political</u>

Licences

The way governments select companies to provide access to the wireless spectrum for 3G and 4G services affects not only the service operators but also the nature and level of demand for different types of handsets.

Standardization

A number of mobile phone manufacturers have agreed to a standard connector for charging phone batteries. This makes life easier for end users but may also contribute to the commoditization of mobile phones; i.e., the process by which mobile phones become indistinguishable from one another and consumers buy solely on price.

Restrictions on usage

Governments place restrictions on the use of mobile phones; for example, on airplanes or in cars. Given that the products of all the handset manufacturers are subject to the same restrictions, these constraints are unlikely to affect the competitive position of a particular handset firm but may provide incentives for new technologies to be developed or might limit the extent to which handsets are substituted for products such as car satellite navigation systems.

Governments around the world are putting pressure on IT-based companies to reveal private information. Hackers put pressure on companie, requiring companies to expend considerable resources keeping their systems secure. Policies in Canada have changed so customers are no longer bound by multi-year service contracts.

<u>Economic</u>

The level of economic activity

During the recession that started in 2008, overall sales of mobile phones slowed significantly but smart phone sales remained buoyant. This suggests that mobile handset providers may be differentially affected by economic fluctuations according to the mix of handsets they offer.

The rapid take-up of mobile technologies in developing economies

Mobile connections offer a more economical and efficient solution than land lines to communications infrastructure problems in many areas, including Africa and India. The geographic focus of different handset manufacturers may have significant implications for their growth rates.

<u>Social</u>

Health scares

Concerns have been raised about the amount of radio waves that people can safely absorb into their bodies when talking on a mobile phone. The mobile handset producers obviously need to be aware of the latest research and adopt appropriate risk management policies.

Changes in fashion

Mobile phones are increasingly being viewed as a fashion accessory by younger people, which creates both opportunities and challenges for handset designers.

Blackberry experienced consumer backlash in October 2011 when there was a worldwide service disruption that lasted for 3 days.

<u>Technological</u>

Rapid change

The mobile handset industry is characterized by rapid changes in technology, which invariably creates winners and losers. Technological improvements that are on the horizon include extensions to battery life, the further development of 4G systems, and more secure encryption.

It proved virtually impossible for any single handset manufacturer to retain leading expertise in the rapidly evolving array of hardware and software technologies associated with this product.

Blackberry used to be the industry leader with regards to technology. Blackberry's new product launches have not been well received by the market. The Blackberry 10 operating system led to negative reviews and a substantial loss of market share.

Ecological

Landfill contamination

The large number of mobile handsets that are being disposed of and the amount of metals and chemical compounds contained within these handsets have created an ecological issue. A small percentage of mobile handsets are being recycled, but the remainder find their way into landfill sites, where there is a risk of toxic contamination of the groundwater.

Legal

Patent infringements

With the rapid change in technological development, the mobile handset industry has seen firms file lawsuits against each other, claiming they are illegally using each other's patented technology. These legal challenges expose firms to delayed launches of their products or potential financial costs related to negative judgements against them.

Porter's five forces of competition framework

Rivalry

Porter suggests that rivalry depends on

- concentration;
- diversity of competitors;
- product differentiation;

- excess capacity and exit barriers;
- cost conditions.

Blackberry's strategy of ignoring the broader market and focusing on business customers for their sales of smartphones was exploited by Apple whose broader market strategy resulted in greater popular appeal and subsequent use by customers both as a personal device and in their business activities. BlackBerry held approximately 40% of the market in 2009; its market share dropped below 1% in 2014.

Threat of Entry

Porter's framework highlights barriers to entry from capital requirements; economies of scale; absolute cost advantages; product differentiation; access to distribution channels; and government and legal barriers. Overall the barriers to entry appear relatively lower in the past so the threat of entry was high. During 2007 and 2008, the world handset market was further shaken up by the introduction of the smart phone, particularly Apple's iPhone and devices using Google's Android mobile operating system.

The Bargaining Power of Suppliers

Handset manufacturers face strong vertical bargaining power from both suppliers and customers. Manufacturers are dealing with powerful suppliers, including the suppliers of digital signalling chips and operating systems (Microsoft, Nokia Symbian, Google).

The Bargaining Power of Customers

The buying power of customers depends on their price sensitivity and their relative bargaining power. Blackberry has not been able to compete effectively from a price/value standpoint. 99% of the market has opted for a competitor's product.

The instructor could suggest that students engage in some more detailed industry analysis and speculate on the value proposition of different customer and business segments.

Substitutes

The price customers are willing to pay for a product depends, in part, on the availability of substitute products. The absence of close substitutes for a product, as in the case of mobile handsets, means that consumers are comparatively insensitive to price (i.e., demand is inelastic with respect to price).

Overall these trends have been depressing industry profitability, despite continued demand growth, especially in emerging markets. During 2000–2005, the industry leaders—Nokia, Motorola, Sony Ericsson, and Samsung—earned an average pre-tax margin of 20.2% on their sales of mobile devices. By 2006–2008, this had fallen to 8.9%, with Motorola incurring substantial losses. By 2014, of the original leaders, only Samsung remained profitable in this industry, with Apple having taken the leadership position in terms of profitability.

2. The practical application of Porter's five forces framework reveals its many limitations. Discuss and suggest ways in which some of the limitations you identify might be overcome.

The key elements of the answer to this question are outlined on pages 45 and 46 of Chapter 2. The practical challenges include defining industry boundaries, deciding on the appropriate level of analysis, factoring in collaborators as well as competitors, and dealing with environmental turbulence. Although it is often argued that Porter's five forces model assumes that industry environments are stable, predictable and bounded, there is a danger of overstating the case. The five forces framework can be used to take snapshots of an industry over time (comparative statics) and in many industries change occurs relatively slowly and in ways that the model can predict. However, there are exceptions. In high-tech

industries, for example, change can be wholesale and very rapid, and when the whole architecture of the industry changes the value of the five forces analysis is diminished.

In the second part of the question you are invited to discuss ways of countering some of the limitations of the model. Your discussion could include a commentary on the significance of industry boundaries (to what extent does the precise delineation of industry boundaries matter anyway?); the use of intra-industry analytical frameworks (market segmentation analysis); the case for (and against) the inclusion of additional forces; and the value of a 'comparative statics' approach (the extent of changes in industry structures).

More sophisticated answers might include some discussion of the limits of rational analytical approaches, characterized by frameworks of this type, and the ways in which such frameworks can shape as well as represent reality. From this perspective, the limitations of the model can only be overcome by recognizing that there are no neutral ways of looking at the world and recognizing that the framework represents a particular worldview.

3. Target is a leading discount retailer in North America, having just expanded from its U.S. base into Canada. Although Target operates over a wide geographic area, most shoppers choose between retailers located within a few kilometres of each other. For the purposes of analyzing profitability and competitive strategy, should Target consider the discount retailing industry to be global, national, or local?

The first stage of industry analysis is to identify the key elements of the industry's structure and, in principle, this is a simple task. It requires identifying who are the main players—the producers, the customers, the suppliers, and the producers of substitute goods—then examining some of the key structural characteristics of each of these groups that will determine competition and bargaining power.

The main rival in this market is Walmart Canada, with additional competition in market segments served by Loblaw's, Sobeys, Canadian Tire, Shoppers Drug Mart, and Sears Canada.

The same considerations apply to the geographical boundaries of markets. Should Target view itself as competing in a single national market or in a series of separate regional or local markets? The key test of the geographical boundaries of a market is price: if price differences for the same product between different locations tend to be eroded by demand-side and supply-side substitution, then these locations lie within a single market. Cross-border shopping can be a factor in markets in close geographic proximity to the USA depending upon exchange rates. On-line shopping is another factor to take into consideration.

In practice, drawing the boundaries of markets and industries is a matter of judgement that depends on the purposes and context of the analysis. Fortunately, the precise delineation of the boundaries of a market or industry is seldom critical to the outcome of our analysis so long as we remain alert to external influences.

Unfortunately for Target, their expansion into Canada cost the company $941 million in 2013, with substantial losses projected for 2014.

4. How would you segment the restaurant market in your hometown? How would you advise someone thinking of starting a new restaurant what segments might be most attractive in terms of profit potential?

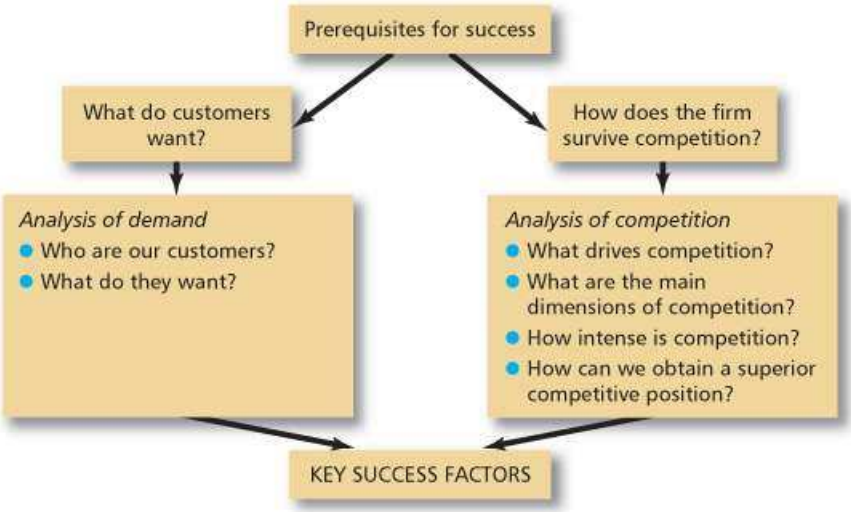
To identify possible segmentation variables, begin with the basis on which consumers choose: e.g., cuisine, location, price level, quality, format (fast food, café, buffet, and waiter service restaurant). We can eliminate location by selecting just local markets. We can then combine the last four variables into a simple composite variable. This gives us just two segmentation variables that can be divided into the following categories:

		RESTAURANT FORMAT		
		Fast Food	**Café**	**Popular Restaurant**
CUSINE	(burgers, steaks, chicken)	McDonald's, Burger King KFC	Harvey's Swiss Chalet	Milestones
	Breakfast coffee	Tim Horton's	Second Cup Starbucks	Cora's
	Italian	Little Caesar's	Pizza Hut	Boston Pizza East Side Mario's Old Spaghetti Factory
	seafood	Joey's		Red Lobster
	Asian	Manchu Wok	Wok Box	

In terms of identifying profitable segments, key criteria might include:

- Where is demand growth strongest (e.g., vegetarian cafes and popular restaurants);
- Where is competition weakest (avoid over-populated segments such as Italian, Fast food popular restaurants), explore segments that are empty or underserved (up-market Asian cuisine, Asian fast food?).

5. What do you think are the key success factors in the: banking industry and mining industry?



Banking industry

What do customers want? (analysis of demand)	How do firms survive competition? (analysis of competition)	Key success factors
● low costs for services	● control costs especially labour costs	● cost efficiency requires technology to provide on-line banking services for labour intensive low complexity tasks
● good customer service	● organizational culture of customer service	● low costs require operational efficiency, scale-efficient branches, low wage costs
● high return on deposits	● identify and acquire assets and investments in attractive markets	● differentiation requires excellent customer service; technologically advanced services

Mining industry

What do customers want? (analysis of demand)	How do firms survive competition? (analysis of competition)	Key success factors
● low prices	● control costs especially extraction, refining and distribution costs	● cost efficiency requires technology to provide maximum return on effort expended to bring the products to market
● consistent quality	● Substantial investment in R&D and process technology	● Consistent quality requires vigilance to ensure products perform as intended in all environments
● environmental stewardship	● Organizational culture and support for safety and protection of environments where resource extraction, development and distribution occurs.	● differentiation requires exceptional safety record; minimal environmental footprint and few or no environmental "catastrophes" i.e., spills, fires, etc.

TEACHING NOTES AND SUGGESTED ANSWERS TO THE SCOTIABANK CASE

A good starting point is to ask students to define the industry. The boundaries of this industry are fuzzy because the organizations operating in this broad field differ significantly in terms of the nature and scope of their activities and range of services they offer.

This case provides students with an immediate introduction to problems of defining industries and highlights the blurred nature of industry boundaries. Instructors could start the session by asking students to think about the boundaries of this industry and the key external factors affecting this industry before they progress to the question on industry analysis.

1. What are the core elements of Scotiabank's strategy?

Sustainable and profitable revenue growth: Collaborating across business lines and geographies provides the best possible solutions for customers.
Capital and balance sheet management: Scotiabank supports growth through active capital, liquidity, and funding management.
Leadership: Attracting the broadest possible spectrum of talent. It is believed at Scotiabank that diversity generates more innovative thinking, better decision making, and stronger business results.
Prudent risk management and appetite: Balancing expectations for growth and performance against acceptable levels of risk in every part of the organization.
Efficiency and expense management: Operating efficiently is in Scotiabank's DNA; it is a core strength and a competitive advantage.

2. Create a PESTEL analysis for Scotiabank.

Political

The Canadian banking system, which is one of the soundest in the world, is based on principles rather than rules, with sound supervision and government policies.
North American and European banks moved toward further regulation, which resulted in increased costs, particularly for banks that had not operated in a highly regulated environment.

Economic

While most emerging markets maintained their growth during this period and into 2011, they subsequently began to be impacted by the economic issues in developed countries. To encourage borrowing and spending, interest rates were lowered, which in turn created a sustained period of lower levels of net interest income for banks.

Social

In addition to the financial impact brought about by the financial crisis of the past decade, customer's trust and confidence in their banks decreased. This has fostered the emergence of non-traditional banking and payment service providers, such as major retail, technology, and telecommunication providers.

Technological

The banking industry has been using technology growth in its operations with the introduction of such services as online banking and remote cash machines. Banks continue to explore the use of technology to reduce costs and increase revenues. The

use of social media in keeping customers informed has enhanced the consumer experience. In addition, it has also allowed banks to employ an analytic strategy whereby customer analytics can be used to improve customer insight, product channelling, risk management, and marketing.

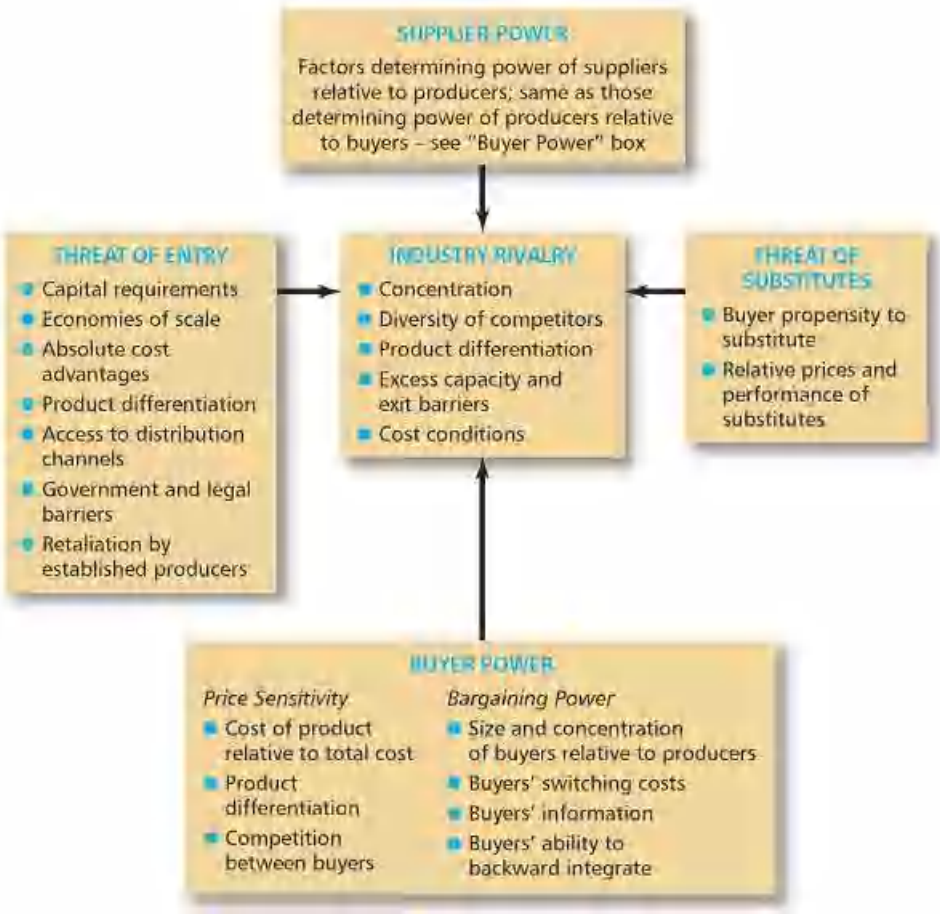
Ecological

In Scotiabank's 2012 annual report, Waugh stated that the Banco Colpatria acquisition "gives Scotiabank a solid footing in Colombia's fast-growing economy, while further extending our presence amongst our peers in the key Latin American markets of Peru, Chile, Mexico and Brazil". Many Latin American development projects are not carried out with the same level of environmental sensitivity, opening the door for social media backlash by environmental groups.

Legal

North American and European banks moved toward further regulation, which resulted in increased costs, particularly for banks that had not operated in a highly regulated environment.

3. Discuss Scotiabank using Porter's five forces of competition framework.



Rivalry

Porter suggests that rivalry depends on:

- concentration;
- diversity of competitors;
- product differentiation;

- excess capacity and exit barriers;
- cost conditions.

The case alludes to many of these factors. For example, concentration appears to be relatively high given the small number of firms in the market. The data in Figure 2.12 can be used to calculate a rough and ready 7 firm concentration ratio. The case suggests that competitors are very concentrated which invites students to speculate on the cost structures of established players in terms of the ratio of their fixed to variable costs. High concentration and low diversity suggest that success in an unstable and slower economic climate will be achieved by organizations that best manage expenses.

Overall rivalry would appear to be moderate. Students should be encouraged to consider the extent to which firms compete on service and to think about the complexity of service strategies in this industry.

Threat of Entry

Porter's framework highlights barriers to entry from capital requirements; economies of scale; absolute cost advantages; product differentiation; access to distribution channels; and government and legal barriers. All of these barriers are applicable in this industry. Overall the barriers to entry appear relatively high so the threat of entry is low.

The Bargaining Power of Suppliers

Students should be encouraged to think of other kinds of suppliers, for example, the suppliers of capital, labour, or land (the sites which banks occupy). It seems reasonable to assume that the bargaining power of suppliers is moderate to low because in all these arenas there are a large number of suppliers in competition with each other.

The Bargaining Power of Customers

The buying power of customers depends on their price sensitivity and their relative bargaining power. The fact that there is little price differentiation in this industry suggests that consumers may not be as price sensitive as we might at first suppose. The instructor could suggest that students engage in some more detailed intra-industry analysis and speculate on the price sensitivity of different customer segments.

With regard to members' relative bargaining power, on the one hand it is relatively easy for consumers to switch banks or to choose to substitute an alternative kind of investment strategy. On the other hand an individual customer has very little clout because he or she is constitutes only a small part of the total business. On balance the bargaining power of buyers in this industry is likely to be low.

In summary the banking industry has been attractive because the external environment produced solid growth prior to the global economic crisis of 2008–2009. The rivalry between existing players and government regulation has led to the erosion of margins and a focus on cost control.

What is the greatest threat to Scotiabank and what is the weakest threat? Explain why.

Greatest Threat

Change in government policy, taxation, and international market growth. In November 2014 ScotiaBank announced a plan to cut 1500 jobs, and close 120 international branches in Mexico and the Caribbean. ScotiaBank underperformed most rivals in 2014 as their international operations were impacted by slowing growth.

Weakest Threat

Threat of entry. The costs and complexity of entering the financial services market provide a formidable barrier to entry.

4. How well is Scotiabank positioned against its competition in terms of products, services, and geographic distribution? How well is it doing compared with the competition?

Aligned to its strategy is a straightforward business model that's anchored in diversification that yielded positive financial results. According to Scotiabank's former CEO, Rick Waugh, the 2012 results "demonstrate Scotiabank's ability to earn through a prolonged period of slower economic growth as well as a more prescribed and rapidly changing regulatory environment."[i] (See Figure 2.11 for a financial snapshot.)

Traditionally, Scotiabank's international scope has enabled the banks shares to trade at a premium. However Scotiabank's international exposure had a negative impact on profitability in 2014, causing it to underperform relative to other Canadian competitors in this industry. Scotiabank's strategy was to divest itself of some of its Caribbean and Mexican operations, and to downsize others.

[i] Scotiabank 2012 Annual Report p. 1