**Industry Analysis**

Recall from the first session that a major tension in business-level strategy is whether it should be resource-driven or market-driven.

The role of market is quite starkly evident in the strategies of console gaming firms. It has become increasingly difficult to develop major next generation breakthroughs in consoles, because they already feature cutting-edge graphics and motion features. Customers are delaying replacing older consoles with the new consoles, and are increasingly switching the use of consoles to watch movies, hurting the ability of console makers to make money by selling many expensive games to console owners. New entrants in social and mobile sectors are offering cheap games that are accessible anywhere online and that have a social aspect and are gaining popularity. Console gaming firms have responded by offering strip-down online versions of their console games, but these strategies have not been successful as they do not offer meaningful experiences the customers are looking for. The challenge is to design the right business model.

Porter’s five forces framework helps to analyze the structural attractiveness of an industry, in order to assess the profit potential of the firms holding intermediate positions within a value system. The objective of the five forces analysis is to improve value capture, as opposed to improving value creation. The analysis assumes that it is not possible to change participant behavior directly; the firms must strive to reposition themselves or change the industry structure in order to bring about a change in participant behavior. For instance by making a market more difficult to enter for others, the behavior of potential new entrants will be impacted, as they will be less likely to enter the market.

The first force is the threat of new entrants. The concept of entry barriers implies that substantial costs, time and investment are required to enter an industry. The higher the entry barriers, the less likely are the new firms to enter the industry. Entry barriers depend on three sub-factors: (1) ease of building supply, which depend on access to difficult-to-trade resources, capabilities, and core competencies, reachable capital requirements, and liberal regulatory policies. (2) ease of building demand, which depend on penetrability of customer relations of existing firms, insufficient switching costs, and rapid market renewal. (3) expected retaliation from existing firms, which depend on their fighting back ability based on resources and historical behavior, their exit barriers, and if the industry growth is sufficient to accommodate additional entrants. Using the opening case, think about how easy is it to build the supply of attractive consoles and popular games in the console gaming industry? How easy has it been for the new rivals to penetrate customer relationships? How strong has been the retaliation from the console gaming firms?

The second force is threat of substitutes. Substitutes limit the potential profits of an industry by placing a ceiling on the prices firms in the industry can charge. The firms should be particularly attentive to those substitute products that (1) show a trend of improving their price-performance ratio, and (2) generate high profits, that may become the basis for the substitute providers to drive cost and price reduction or performance improvement and differentiation. The position of the firms relative to the substitute providers is generally a matter of collective action by the industry participants. Product quality improvement, product availability, and product differentiation and advertising by a single firm may not be sufficient to improve the industry’s position against a substitute. However, heavy and sustained efforts by all participating firms can improve the industry’s collection position. Using the opening case, how effective have been the firms in responding to the threat of online substitutes?

The third force is bargaining power of buyers. Buyers’ forcefulness to bargain depend on three sub-factors: (1) their need for superior terms of purchase, such as because of the low profitability of their industry, or because their purchases from our industry constitute a significant portion of their costs, (2) their leverage over our industry, such as because of their knowledge about our industry, or their power to negotiate, and integrate backward into our industry, and (3) their ease of substitution, such as because the products offered by our industry are undifferentiated and standard, or because they do not involve much switching costs. Using the opening case, how satisfied are the customers with the terms of purchase offered, and how easily are they able to switch to alternative experiences.

The fourth force is bargaining power of suppliers. An industry may have several supplier groups, and each group’s forcefulness to bargain depend on three sub-factors mirroring the buyer force: (1) Its need for superior terms of sale, such as because of the low profitability of its industry, or because our industry’s purchases are not of great importance to it – such as because they constitute only a small portion of its overall revenues; (2) Its leverage over our industry, such as because of its knowledge about our industry, or its power to negotiate, and integrate forward into our industry; and (3) Its difficulty of substitution, such as because the products it offers are proprietary and differentiated, or because they involve significant switching costs. Concept of suppliers includes not only the other firms providing intermediate inputs, equipment, and services, but also the labor. In the opening case, this force is of limited importance.

The fifth force is intensity of rivalry among competitors. It depends on three sub-factors: (1) Presence of numerous, equally balanced, or diverse competitors – all of which intensify the rivalry. Intensity of rivalry is usually inversely correlated with the industry concentration ratio, i.e. what share of the market is held by the top four firms. More concentrated industries experience lower rivalry, (2) When an industry is growing slowly, or is in a mature or disruptive phase, firms fight to keep their share. In such markets, products become like commodities, with little non-price differentiation and more price-based competition, (3) High exit barriers make firms reluctant to exit from the industry, because of their emotional commitments, cognitive stakes, economic costs, or regulatory sanctions. This results in persistence of inefficient operations, and more rivalry.

A major limitation of the Five Force’s framework is that it does not consider the direct effects of either the macro factors such as politics and new technologies, or micro behavioral factors such as cognitions, emotions, and social relations, on the profit potential of an industry.

The structure of the market, and therefore the nature of five forces, varies depending on the type of market structure.

There are two typologies of market structures – one based on the niche density (i.e. the number of competitors), and the other based on carrying capacity (i.e. the industry lifecycle). In economic theory, four major types of traditional markets are identified based on the number of competitors: (1) Monopoly (single firm), (2) Oligopoly (a few firms), (3) Monopolistic competition or niche markets (many firms), and (4) Perfect competition (numerous firms). Another important structural characteristic is the industry lifecycle. Similarly, in strategy literature, four types of markets are identified based on the industry lifecycle: nascent markets, hyper-competition, dominant firm, and fragmented market. Each of these market structures offers differing constraints, opportunities and incentives to the firms. Therefore, each market structure encourages distinctive types of competitive gaming behaviors.

Let’s review the competitive behaviors under market structures based on number of competitors.

Monopoly refers to a market structure with only one firm. The monopoly firm is largely free to decide its own price, output, and other product and service features. Monopolists are known to engage in a range of tactics, or games, to impede the entry and success of other entrants: “predatory pricing”, “essential facility denial”, “vaporware”. In the Internet era, new types of monopolies – referred to as creative monopolies – have emerged, who are actually helping to cut the monopoly power of suppliers, and transfer value back to the consumers (for example, Amazon).

Oligopoly comprises of a few large firms that perceive one another as mutually inter-dependent. There exists an intense rivalry along several dimensions, such as price, quality, brand image, and market share. Success requires firms to consider the effects of their actions on the competitors’ behavior. It is best for a firm to strike a balance between industry level cooperation (to avoid profit eroding warfare) and firm level competition (to avoid giving up potential revenues and profits). New evidence suggests that most oligopolistic markets tend to become ineffective because of collusive tendencies, and ripe for creative destruction by new firms.

Niche markets consist of market segments within the larger marketplace that emphasize a particular need, or geographic, demographic or product segment but that differ along some key dimensions from other market segments in the marketplace. Firms have two options for value differentiation in niche markets: vertical (alternative price-quality tradeoffs) and horizontal (alternative similarly priced qualities for different target groups).

Perfect competition is characterized by the lack of significant fixed costs or investments, and running business largely on variable costs. The firms tightly monitor their variable costs, and compete on efficiency. Though basic economic theory considers perfect competition to be the ideal state for social welfare, it does not provide effective conditions for the growth of the firms or the industry. It often invites fly-by-night players to make a fast, extra buck by free riding on the public goods and social infrastructure. A key insight is when the access to infrastructure, technology and knowledge is based on the pay per use model, more firms are likely to enter the market with limited risks of huge losses if they fail. Such pay per use model thus can engender several creative endeavors and promote innovation and growth.

Let’s review the competitive behaviors under market structures based on industry lifecycle.

Nascent competition markets are usually spurred by technological innovation, newly emerging customer needs, and economic and sociological shifts. A distinguishing characteristic of the nascent competition market is the lack of any “rules of the game”, and a competitive race among the firms. The success requires winning the competitive race on several fronts: improving the functionality of the technology, forging advantageous relationships with channel partners, acquiring a core group of loyal customers, accessing patient venture capitalists and entrepreneurial human capital, and moving fast to develop a network of players who commit to the use of firm’s technology as the reliable, cost-effective and dominant one.

Hyper-competitive market is turbulent and fast changing where the rules of game are continually shifting, spurred by the processes of globalization and information economy. The firms therefore seek to distribute up-front investment requirements, either across a network of firms or over time. A firm competing on the edge of hyper-competition thrives on the “guerilla advantage”.

Dominant firm structure comprises of a single large firm at the core, and several smaller firms at the periphery of the market. The dominant firm generally enjoys a competitive advantage based on the lower costs deriving from early entry and “learning-by-doing”, large economies of scale, and proprietary technology; the smaller firms focus on niches that are not profitable or attractive for the dominant firm, due to factors such as smaller scale, idiosyncratic resources and knowledge bases, and customized services of the smaller firms in their target markets. A special form of the dominant firm is the vertical dominance, where a dominant firm forms captive vertical relationships with vendors and distributors.

Fragmented structure is one where no firm has a significant market share to strongly influence market outcomes. While the products tend to be expensive and not very well developed, the success depends on keeping the costs low using a “bare bones” approach with low overheads, minimum wage employees, and tight cost control. A fragmented structure often arises when the government breaks-up a monopoly, or deregulates entry into an erstwhile monopoly market. There are three major approaches for consolidating a fragmented market: mergers and acquisition involving fragmented firms, codification of the effective practices and franchising to replicate those practices, and verticalization involving the use of information technology to coordinate the entire supply chain.

The case on the entertainment industry shows how the opportunity levels in the entertainment industry are tremendous. For consumers, today is an age of absolute abundance in entertainment. More content is available in more ways than ever before. For content creators, it is an age of amazing new opportunity. More people are making more money from creating content than ever before. And, for the traditional middlemen, the internet represents both a challenge and an opportunity. However, as competition is intensifying, the challenge is how to best capture the value presented by the opportunity. Because of the shifting five forces, shifting market structure types, and shifting diamond conditions, the old business models and strategies are becoming less effective, and there is a need for new business models and strategies. The case of Napster is particularly instructive. How have Napster and other developments in the entertainment industry transformed the power of the five forces and the type of market structure in the US?