1-3: Analysis of Market Situations

To prepare for this lecture, read any summary of Michael Porter’s Five Forces model, such as the one publicly available at [http://www.quickmba.com/strategy/porter.shtml](http://www.quickmba.com/strategy/porter.shtml), as well as “Competing for Advantage”, chapter 7 in Sharon M. Oster, *Modern Competitive Analysis*, 3rd ed., which is available to enrolled students via Angel.

In this lecture we will look at two models for analyzing the source and sustainability of economic profits. These models in no way exhaust the possibilities for ways of thinking about industry analysis, but they are two of the most well-known.

**Industry Analysis**

1. **Porter’s five forces approach.** This is a framework for industry analysis and business strategy development developed by Michael Porter in his 1980 book *Competitive Strategy*. It draws upon Industrial Organization (IO), focusing on five forces that, according to Porter, determine the competitive intensity of a market. From our perspective, these five forces offer a useful way of thinking about how sustainable abnormal returns might be for a firm operating in a given environment. The five forces are summarized here:

   ![Porter's Five Forces Model]

   **Threat of New Entrants**
   - Economies of scale
   - Product differentiation
   - Capital requirements
   - Switching costs to buyers
   - Access to distribution channels
   - Other cost advantages
   - Government policies
   - Incumbents’ defense of market share
   - Industry growth rate

   **Determinants of Supplier Power**
   - Supplier concentration
   - Availability of substitute inputs
   - Importance of suppliers’ input to buyer
   - Suppliers’ product differentiation
   - Importance of industry to suppliers
   - Buyers’ switching cost to other input
   - Suppliers’ threat of forward integration
   - Buyers’ threat of backward integration

   **Rivalry Among Existing Firms**
   - Number of competitors (concentration)
   - Relative size of competitors (balance)
   - Industry growth rate
   - Fixed costs vs. variable costs
   - Product differentiation
   - Capacity augmented in large increments
   - Buyers’ switching costs
   - Diversity of competitors
   - Exit barriers
   - Strategic stakes

   **Determinants of Buyer Power**
   - Number of buyers relative to sellers
   - Product differentiation
   - Switching costs to use other product
   - Buyers’ profit margins
   - Buyers’ use of multiple sources
   - Buyers’ threat of backward integration
   - Suppliers’ threat of forward integration
   - Importance of product to the buyer
   - Buyers’ volume

   **Threat of Substitute Products**
   - Relative price of substitute
   - Relative quality of substitute
   - Switching costs to buyers

   ![Porter's Five Forces Model]

   - How would you apply this model to a well-known firm such as Exxon-Mobil or Wal-Mart?
2. **Oster’s cost advantage and product differentiation approach.** Drawing on the same type of analysis as Porter, Sharon Oster elaborates a framework in which firms are able to secure and maintain abnormal returns (positive economic profits) by either maintaining a technological or cost advantage in production or by creating and sustaining an impression of superior value over competitors. Her framework is summarized here:

**Oster’s Differentiation and Cost Advantage Model**

\[
\begin{align*}
V_A &= \text{A's advantage attributable to product differentiation} \\
V_O - C_O &= \text{Normal economic profit} = 0 \\
C_A &= \text{A's advantage attributable to cost efficiency}
\end{align*}
\]

Where:

- \( V_A \) = Value of firm A’s product or service to the consumer
- \( V_O \) = Value of average competitor’s product or service to the consumer
- \( C_O \) = Average competitor’s economic cost of production per unit
- \( C_A \) = Firm A’s economic cost of production per unit

Establishment of product differentiation in the minds of consumers confers upon a seller a degree of market (or monopoly) power that can sustain profits if protected by a **barrier to entry**. To these two factors – differentiation and cost advantage, Oster adds a third source of positive economic profit that is less quantifiable – entrepreneurial skill. Thus, her arguments about the source and sustainability of positive economic profits may be summarized as follows:

**Market Power:** Excess returns may result from exploitation of a protected environment where entry is difficult.

**Entrepreneurial Activity:** Excess returns may be attributable to an ability to anticipate and rapidly exploit new opportunities.

**Organizational Advantage:** Excess returns may result from possession of a sustainable competitive advantage, such as cost efficiency, over potential and actual rivals.

For another example of the managerial literature’s treatment of the subject matter of this lecture, read Hambrick and Fredrichson, “Are you sure you have a strategy?”, *Academy of Management Executive* 19:4 (2005), 51 – 62, which is available to enrolled students via Angel.

**Exercise:** Select a business firm and analyze its potential for sustainable positive economic profits by applying Porter’s five forces model.