

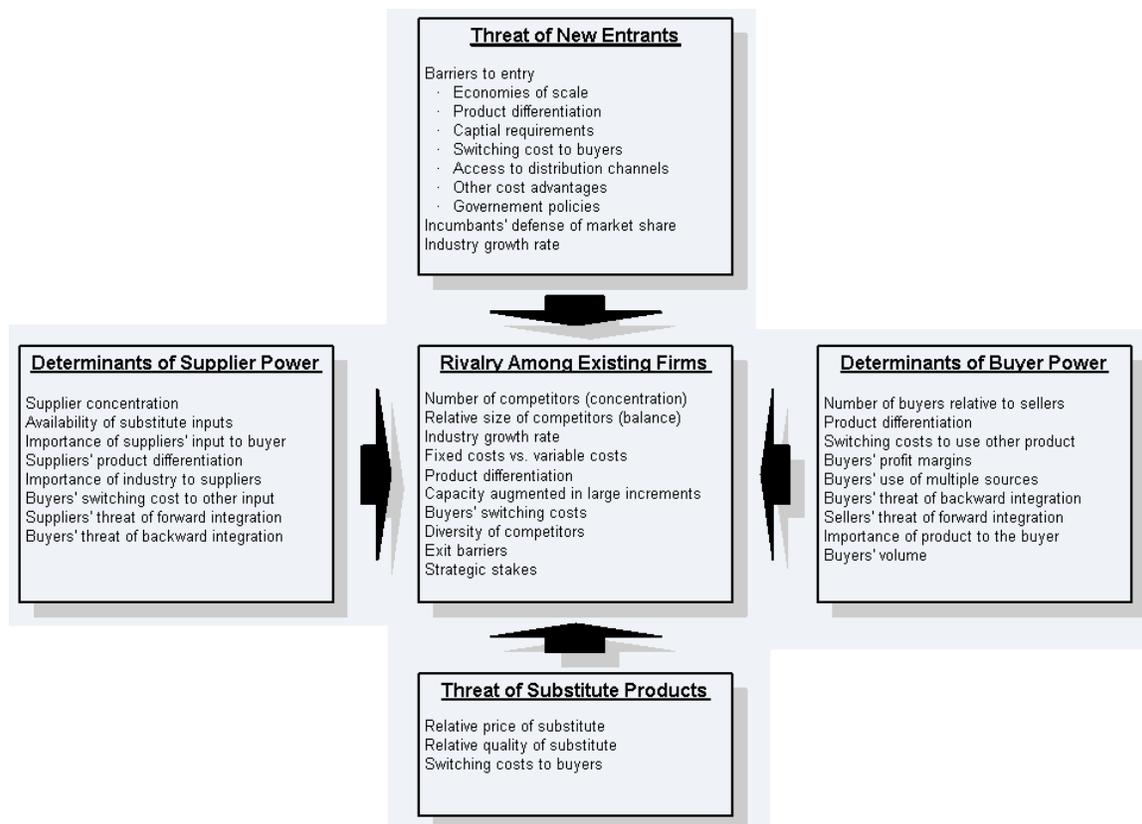
1-3: Analysis of Market Situations

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>, 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

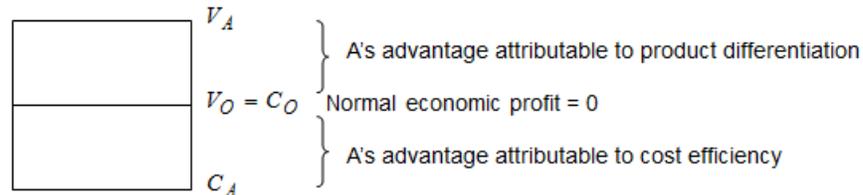
1. *Porter's five forces approach*. This is a framework for industry analysis and business strategy development developed by Michael Porter in his 1980 book *Competitive Strategy*. It draws upon Industrial Organization (IO), focusing on five forces that, according to Porter, determine the competitive 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:



? 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



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.