Strategy Frameworks
Contents

Sources of Competitive Advantage framework

Five forces framework

Value-net framework
A firm's profits depend on how much value (economic surplus) it creates, and how much of that surplus it obtains as profits.

**ECONOMIC SURPLUS AND PROFITS**

- **Willingness to pay**
- **Price**
- **Cost**
- **Gross customer valuation**
- **Cost of production**
- **Consumer surplus**
- **Profit**
- **Cost**
- **Total economic surplus, or, Economic value created**
There is usually some rate at which customers are willing to trade off price and quality

A PRICE-QUALITY INDIFFERENCE CURVE
A firm can have a cost-based advantage if it can lower costs by more than it must lower price.

A COST-BASED COMPETITIVE ADVANTAGE
There are many different potential sources for cost advantages

GENERAL COST DRIVERS

– Cost drivers related to firm size or scope (economies of scale, economies of scope, capacity utilization, specialization)
– Cost drivers related to cumulative experience (learning curve)
– Cost drivers related to the organization of transactions (vertical integration, long-term contracts, management and control)
– Other cost drivers (input prices, location, economies of density)

Hard decision is when something must be sacrificed in order to obtain a cost advantage.
A firm can have a differentiation-based advantage if it can raise price by more than it must increase costs

A DIFFERENTIATION-BASED COMPETITIVE ADVANTAGE
There are many different potential sources for differentiation advantages

GENERAL BENEFIT DRIVERS

– Physical characteristics of product (performance, durability, quality, features, aesthetics, ease of use)
– Quality of complementary goods (postsale service, spare parts, warranties, maintenance and repair services)
– Characteristics associated with sale or delivery (timeliness, convenience, credit, location, quality of sales staff)
– Characteristics that shape consumers' perceptions or expectations (reputation, installed base, network externalities)
– Subjective image (prestige, status)

Again, hard decision is when something must be sacrificed in order to obtain a benefit advantage.
If customers differ in their price-quality trade-off, strategic choices are expanded

HETEROGENEOUS PRICE-QUALITY PREFERENCES

![](image)
If customers differ in their preferences over attributes, firms can have competitive advantage in a niche

NICHE-BASED ADVANTAGE

– For some products, customers do not agree about what makes a quality product
– For example, which is the better product?
  • Coke or Pepsi?
  • Windows or Mac OS?
  • Harley-Davidson or Ducati?
  • "Sense and Sensibility" or "Lara Croft Tomb Raider"?
– For such products, firms can have a competitive advantage if they serve well a particular niche.
– In order to be successful at such a strategy, firms must...
  • differentiate on attributes customers really care about
  • have a large enough niche
  • be able to produce at a low enough cost given prices that can be charged
Which strategy a firm should pursue depends on the options that are available given its cost structure, customers, etc.

<table>
<thead>
<tr>
<th>COST-BASED WHEN...</th>
<th>BENEFIT-BASED WHEN...</th>
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<tbody>
<tr>
<td>– Economies of scale are potentially significant but unexploited</td>
<td>– Some customers are willing to pay a premium for quality</td>
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<td>– There are few opportunities to enhance benefits</td>
<td>– Customers are heterogeneous in their preferences</td>
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<td>– Customers are price sensitive, or unwilling to pay a premium for quality</td>
<td>– Learning or economies of scale are exploited already</td>
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<td>– A firm is likely to differ from competitors in cost</td>
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Five forces framework

Value-net framework
Industry analysis, or "five forces" analysis, is a tool to understand the profitability of an industry.

**FIVE FORCES FRAMEWORK**

What is the threat to profits from...?

- Supplier power
- Substitutes
- Rivalry with competitors
- Buyer power
- Entry

Industry analysis is a useful tool for understanding a firm's economic context.
Force 1: Rivalry with competitors dissipates industry profits through low prices

RIVALRY WITH COMPETITORS

– Characteristics of the market that threaten profits through fierce rivalry:

• many sellers
• homogeneous products
• low buyer switching costs
• buyers motivated to search, willing to shop for price
• large and infrequent (lumpy) sales
• excess industry capacity and/or declining demand
• cost structure with high fixed costs, low marginal costs

– Measures of rivalry

• 4 or 8 firm concentration ratio: Combined market share of the largest 4 or 8 firms
• Herfindahl-Hirschmann Index (HHI): Sum of squares of market shares of all firms

If a firm lowers its price a little, its sales are likely to increase a lot
Force 2: Entry both lowers market share and affects rivalry

ENTRY

– **Characteristics** of the market that threaten profits by making entry easy:
  
  • no economies of scale, low minimum efficient scale relative to the size of the market
  
  • no learning or experience curve
  
  • easy access to inputs and distribution
  
  • necessary technology is readily available to entrants (patents, trade secrets, and intellectual property not important)
  
  • no strong brand identity or reputation for incumbents
  
  • low exit costs (?)

– **Measures** of ease of entry

  • estimated cost of entry at minimum efficient scale
  
  • time to recoup initial investment
Force 3: Substitutes are analogous to entry, but with a different product instead of a different producer

**SUBSTITUTES**

- **Characteristics** of a product that threatens profits by substitutability:
  - fulfills the same customer need (whether or not a similar product)
  - similar performance characteristics, availability, ease of use, etc.
  - similar cost per unit of usage

- **Measures** of substitutability
  - Antitrust: Would a 5-10% increase in the price of good X increase the demand for Y? If so, the products are substitutes.
  - Cross price elasticity: \( \frac{\%\Delta Q_Y}{\%\Delta P_X} \)
    => If the cross price elasticity is positive, X and Y are substitutes.
    => If the cross price elasticity is negative, X and Y are complements.
Force 4: Supplier power is the ability of suppliers to extract profits by obtaining high prices

SUPPLIER POWER

– Characteristics of the market that threaten profits through supplier power:
  • relatively few suppliers
  • inputs are difficult to substitute
  • firm must make specific investments in order to use inputs purchased from supplier
  • supplier has the ability to integrate forward
  • Note: just because an input is vital or critical does not mean that there is supplier power

– Measures of supplier power
  • Price - cost margin of supplier
Force 5: Buyer power is the ability of buyers to extract profits by obtaining low prices

BUYER POWER

- **Characteristics** of the market that threaten profits through buyer power:
  - relatively few buyers, each a large fraction of sales
  - firm must make specific investments in order to serve the needs of the buyers
  - buyers has the ability to integrate backward into supplying their own inputs
  - Note: Buyer power is related to rivalry with competitors (lumpy sales, low switching cost, etc. tend to increase buyer power).

- **Measures** of buyer power
  - Conceptually, would like to measure difference between willingness to pay and price.
  - Practically, no general way to do this.
Industry analysis has strengths and weaknesses

STRENGTHS OF INDUSTRY ANALYSIS

– Constructs a useful background picture of issues that will be important in developing strategies
– Useful checklist

WEAKNESSES OF INDUSTRY ANALYSIS

– Focuses on an industry, although profits are not uniform among firms in an industry
– Do industry analysis does not spell out the right strategy; after the industry analysis is when the heavy lifting begins
– Leaves out the government, which is important in regulated industries
– Leaves out the effect of complements, which are the mirror image of substitutes. More, better, and cheaper complements will raise industry profits.
What can firms do in an industry that five forces analysis paints as unattractive?

COPING WITH THE FIVE FORCES

– Figure out how to outperform competitors (competitive advantage)
– Find an industry segment or niche market with more favorable conditions
– Try to change the five forces
  Examples:
  • Pharmaceuticals are a large and increasing share of health care expenses. Patents give pharmaceutical companies a lot of supplier power.
  => Hospitals form buying cooperatives or HMOs to increase negotiation power
The tobacco industry provides a simple example of industry analysis

INDUSTRY ANALYSIS OF TOBACCO

What is the threat to industry profits from...

Rivalry with competitors
– Four firm concentration ratio is 92%
– Competition in promotions rather than price

Entry
– Economies of scale in producing cigarettes
– Strong brand loyalty
– Existing producers have favorable access to distribution and retail

Substitutes
– Tobacco is addictive
– Chewing gum? Nicotine patch? Chewing tobacco?

Supplier power
– Tobacco is a (subsidized) commodity
– Labor? Paper?

Buyer power
– Distributors and retail outlets are small and fragmented
Industry analysis suggests tobacco industry should be profitable

TOBACCO INDUSTRY CONCLUSIONS

– Profitability
  • Average price-cost margin is 65%, meaning 65% of price is profit

– Are there any threats to profitability?
  • Government regulation
  • Government enforcement of outcomes of litigation

– What can the industry do to deal with remaining threat?
  • Financial penalties can be passed on to customers because addictive nature means demand is inelastic
  • However, new (young) smokers are more price elastic. Combined with advertising restrictions, could mean problems for the industry down the road
  • Exporting beyond the reach of the U.S. government
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The Value Net is an analytical strategy tool based on added value and game theory

- What are the sources of value in a firm’s interactions?
- How can it increase the total value created?
- How can it increase its own added value, and the share it gets as profits?

```
  Suppliers
     /\    /
    /   \  /   \
   /     \|     \
  Competitors       Company       Complementors
     \    /     \
      \  /      \
       \|       \
        Customers
```
The vertical axis (suppliers-company-customers) is the basic source of value (or economic surplus) creation

- Total economic surplus along this axis is the customers valuation, minus your supplier’s cost of production, minus your production costs not counting input costs
- The price you charge your customer, and the price your supplier charges you determines how this surplus is divided.
Competitors reduce your added value along the vertical axis

- A competitor reduces your added value to your customers.
  - Another airline serving the same route (same product)
  - Aluminum recycling and extraction (different products)
- A competitor reduces your added value to your supplier
  - Two pharmaceutical firms competing to license from a biotech firm
  - Electric utilities and coal contracts
Complementors increase your added value along the vertical axis

- A complementor increases your added value to your customers.
  - Game developers are complementors for video game systems
  - Park City restaurants are complements for Park City ski resorts
- A complementor increases your added value to your supplier.
  - If another airline buys the same planes from Boeing you do, they share the R&D expense
  - When your neighbors use WebVan its cheaper to serve you