Competitive Strategy

Techniques for Analyzing Industries and Competitors

Michael E. Porter

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KEY CONCEPTS

• **Gauge the intensity of the forces driving an industry’s competition.** A firm must determine its potential for profitability by measuring the strength of the five competitive forces in its industry: the threat of new industry entrants, the intensity of existing rivalry, pressure from substitute products, bargaining power of buyers, and bargaining power of suppliers.

• **Pick a generic strategy—and stick to it.** To develop a competitive advantage within an industry, a firm must commit to a strategy of low-cost leadership, product differentiation, or narrow customer target focus.

• **Predict a competitor’s future moves.** A firm can gain competitive advantage by conducting competitor analysis to determine how likely competitors are to enact aggressive strategies in the future and then developing a plan to counter these strategies.

• **Execute the appropriate competitive move.** A firm can choose to improve its own position or worsen its competitor’s by choosing a cooperative, threatening, or defensive competitive move to enact.

• **Determine a firm’s relative profitability by mapping the industry out into strategic groups.** To conduct an industry analysis, a company must divide all of an industry’s firms up into “strategic groups” and then assess each group’s susceptibility to every one of the five competitive forces.

• **Look to common “evolutionary processes” to forecast the nature of an industry’s evolution.** To anticipate necessary strategic adjustments, a firm must consider the likelihood of its industry being affected by “evolutionary processes” like new entrants, innovations, and customer segments.
• Enter unstable industries only with a thoroughly developed competitive strategy. While emerging, fragmented, and declining industries can be lucrative, they are also highly unstable and require firms to carefully construct strategies in order to outperform competitors and succeed.

• Compete in global industries when impediments are minimal. It is worthwhile for a firm to compete in a global industry when there are limited economic, managerial, and institutional impediments to overcome.

• Expand capacity only when an analysis determines it will improve market returns. A firm should expand its production capacity when it can increase its cash flow without the risk of overbuilding.

• Enter a new business through the strategies of either internal development or acquisition. When entering a new business, firms should opt for internal development in industries where retaliation is unlikely, and choose the strategy of acquisition when it is affordable and it does not eliminate above-average returns through the bidding process.

INTRODUCTION

In Competitive Strategy, world-renowned strategy consultant and author Michael E. Porter provides readers with a groundbreaking framework to conduct in-depth industry and competitor analysis. Through a series of tools and techniques, Porter illustrates how this analysis can be utilized to develop effective strategies to both improve a firm’s position among its competitors and increase overall profitability. Competitive Strategy is the essential guide to developing and sustaining a firm’s success in the world’s most competitive industries.

THE STRUCTURAL ANALYSIS OF INDUSTRIES

The more competitive the industry, the less likely its firms are to have high returns. According to Porter, there are five basic competitive forces responsible for the state of competition in an industry. To develop an effective competitive strategy, a firm must first measure the level of each competitive force in its industry.

The five competitive forces are:

1. The threat of new entrants. New industry entrants threaten incumbent firms’ market shares and access to resources. Industries are susceptible to this threat when “entry barriers,” like large capital requirements and strict government policies, are low and the retaliation of incumbent firms against newcomers is unlikely.

2. Intensity of rivalry among existing competitors. Intense rivalry is the result of structural factors like numerous competitors of equal power or slow industry growth. High “exit barriers,” or the economic and strategic factors that keep companies in an industry even with low ROI, can also intensify rivalry.

3. The threat of substitute products. The more attractive the prices of substitute products from industry competitors, the more limited the industry’s potential profitability.

4. The bargaining power of buyers. The more powerful an industry’s buyer groups are, the less profitable the industry. Powerful buyers are typically responsible for a large portion of sales.

5. The bargaining power of suppliers. By threatening to raise prices or reduce the quality of purchased goods and services, suppliers can greatly reduce the profitability of an industry. The less dependent a supplier is on a particular buyer or industry, the more powerful it is.
**Generic Competitive Strategies**

To cope with the five competitive forces and outperform its competitors, a firm must completely commit to one of the following three “generic strategies”:

1. **The Overall Cost Leadership Strategy.** Firms attain a low-cost position relative to their competitors and above-average returns through the vigorous pursuit of production and sales cost reductions while never compromising quality.

2. **The Differentiation Strategy.** Firms create something unique within the industry in the form of design, brand image, or a new technology. Differentiation cultivates a sense of exclusivity, brand loyalty, and high profit margins.

3. **The Focus Strategy.** Firms earn above-average industry returns by focusing on a specific buyer group, segment of the product line, or geographic market. This strategy requires a firm to take a low-cost position with its strategic target, a high differentiation position, or both.

**A Framework for Competitor Analysis**

By conducting *competitor analysis*, it becomes possible for a firm to predict the strategies a competitor is likely to enact in the future. Consequently, this process allows a firm to determine which industry competitors to go up against and which ones to avoid.

Competitor analysis is comprised of the following four diagnostic components:

1. **Future Goals.** An analysis of a competitor’s goals reveals its satisfaction with its current position and subsequent likelihood of changing strategies. To identify a competitor’s goals, it is necessary to ask diagnostic questions about its financial objectives, attitude towards risk, incentive systems, and whether it has a corporate parent imposing additional goals.

2. **Assumptions.** Every firm operates on a set of assumptions about its role in the industry it competes within. Assumptions are exploitable blind spots and can be identified by questioning the competitor’s history, organizational values, and leadership.

3. **Current Strategy.** To understand the current strategy of a competitor, it is necessary to examine both its key operating policies in each functional area of business and how it connects each function to one another.

4. **Capabilities.** To assess a competitor’s capabilities, it is necessary to measure its performance in each functional area. By identifying what the competitor is best and worst at, and if it has the ability to grow, it becomes possible to predict which strategic moves it will make.

A *market signal is any action by a competitor that provides a direct or indirect indication of its intentions, motives, goals, or internal situation.*

A competitor response profile combines all four components of competitive analysis and defines two types of possible action:

1. **Offensive Moves.** Predict the strategic changes the competitor might initiate considering its satisfaction with its current position, goals, assumptions, and capabilities.

2. **Defensive Capabilities.** Consider what strategic moves or industry changes the competitor would be most vulnerable to, which ones would cause them to retaliate, and what actions could impede it from reacting too quickly and effectively.
MARKET SIGNALS
A firm's ability to recognize and read market signals is essential to developing an effective competitive strategy. A market signal is any action by a competitor that reveals its intentions, motives, or goals. Market signals can be truthful indications of a competitor's motives, or bluffs. Examples include:

- Prior announcement of moves. Prior public announcements can act as a signal that a firm is staking out industry territory or coalescing internal support for a move.

- Public discussions of the industry. Competitors' comments on industry conditions can forecast demand and production prices and reveal the industry assumptions the competitors may be constructing their strategies around.

- Explanation of moves. When a competitor seeks to explain its moves, it is usually done to discuss its logic, deter other firms from making the same move, or communicate commitment.

COMPETITIVE MOVES
In industries dominated by numerous competitors, a firm is faced with the decision of making offensive moves to improve its own position or defensive moves to derail its competitors' success. The decision to execute an offensive or defensive competitive move depends on the structure of the industry—industries with high levels of competition, for example, may require soft treading to prevent outright warfare.

After conducting an analysis to determine an industry's nature, a firm must execute one of the following:

- Cooperative move. A nonthreatening move that increases a firm's profits but does not negatively affect the performance of its competitors.

- Threatening move. A move that significantly improves a firm's position while threatening its competitors. This move's success depends on slow or weak competitor retaliation.

- Defensive move. A firm can successfully retaliate against a competitor by preventing the competitor from meeting its sales goals. This can be accomplished by publicly attacking the competitor's new products or by having a deal that steals their customers away.

STRATEGY TOWARDS BUYERS AND SUPPLIERS
At its core, the basic strategic principle in "buyer selection" is for a firm to seek out the most favorable wholesaler or retailer groups by using the following four criteria to help guide the process:

1. Purchasing needs relative to a firm's capabilities. The firm's production capabilities fit the target buyer's purchasing needs.

2. Good growth potential. Buyer group growth potential is a combination of the growth rate of the industry, the growth rate of its primary market segments, and its industry and key target market share.

3. Structural position. A buyer group's structural position is the result of its intrinsic bargaining power and its propensity to exercise this bargaining power. Ideal buyer groups have limited bargaining power.

4. Cost of servicing. Cost of servicing is affected by a buyer's order size, required lead times, selling cost, and the need for customization or modification.
An effective purchasing strategy is one that offsets suppliers' power. Firms can accomplish this by spreading their purchases among alternate suppliers, avoiding switching costs, and acquiring bargaining leverage with suppliers through the threat of backward integration, or the purchase of suppliers.

**Structural Analysis Within Industries**

Structural analysis of an industry is comprised of the following steps:

1. Organize the industry competitors into strategic groups, or groups of firms divided among the same strategic dimensions. Examples of strategic dimensions include specialization, technological leadership, and price policy. Strategic groups should be written out into an industry map to make it easier to identify each group's level of sustainable profitability.

2. Assess and note the height and composition of the mobility barriers protecting each strategic group. Strategic groups with high mobility barriers are more protected against new entrants and therefore have a higher level of profitability.

3. Assess and note the relative bargaining power of each strategic group with its suppliers and buyers. Some will have strategies that make them more vulnerable to common suppliers and buyers.

4. Assess and note how vulnerable different strategic groups are to the threat of substitute products.

5. Assess and note the pattern of strategic groups' market interdependence, or the degree to which different strategic groups are competing for customers, and identify how vulnerable each strategic group is to warfare initiated by other groups.

Once an industry analysis has been conducted, the following factors should be considered to determine a specific firm's profitability within its industry:

- **Common industry characteristics**—The relative strength of the five forces in that particular industry.
- **Characteristics of strategic group**—The relative levels of each of the five forces in the firm's strategic group.
- **Firm's position within its strategic group**—The firm's position within its strategic group is determined by the degree of competition within the strategic group, the scale of the firm relative to others in its group, costs of entry into the group, and the ability of the firm to implement its chosen strategy.

**Industry Evolution**

As industry structures often evolve over time, a firm must be able to make strategic adjustments in order to survive. This requires an understanding of evolutionary processes, or the forces that create pressures and incentives for industry change. Although every industry is different, common evolutionary processes should be considered to forecast industry change. Some examples include:

- **Changes in buyer segments served.** The addition of new buyer segments or the elimination of obsolete segments can fundamentally transform an industry's structure.

- **Expansion (or contraction) in scale.** As the size of an industry changes, so does the size of its leading firms and the types of new entrants.
• **Product, marketing, and process innovation.** These types of innovations can widen the market, increase demand, and make the process more or less capital intensive.

• **Government policy change.** New government policies can affect an industry’s competitive practices or profitability.

• **Entries and exits.** New entrants can transform the structure of an industry while the exit of existing firms can increase the dominance of leading ones.

**Competitive Strategy in Fragmented Industries**

A **fragmented industry** is one in which no single firm has enough market share to truly influence the industry’s outcome. Overcoming a fragmented industry can be an excellent strategic opportunity for a firm thanks to low entry barriers and the unlikelihood of competitor retaliation. Firms can consolidate a fragmented industry for significant market share by introducing new products or marketing innovations, standardizing the industry’s diverse market needs, or by recognizing and harnessing industry trends early on. To formulate an effective competitive strategy for a fragmented industry, Porter recommends the following steps:

1. Conduct a full industry and competitor analysis.
2. Identify the causes of fragmentation in the industry.
3. Examine the causes of industry fragmentation in the context of the industry and determine if any of these sources can be overcome with innovation or strategic change.
4. If fragmentation can be overcome, assess whether or not the implied future structure will yield attractive returns by predicting the new structural equilibrium in the industry once consolidation occurs, and then conduct another structural analysis.
5. If fragmentation cannot be overcome, select the best alternative for coping with the fragmented structure, like tightly managing decentralization or specializing in a product or customer segment.

**Competitive Strategy in Emerging Markets**

**Emerging industries** are industries that have been formed or reformed thanks to the introduction of forces like new technological innovations or customer needs. Although emerging industries can be lucrative, they are also subject to problems like an absence of infrastructure, customers’ confusion, and erratic product quality. To succeed in an emerging industry, a firm must make the crucial strategic choice about when to enter. While early entry often comes with high returns, it should only be considered if the firm can develop a reputation as a pioneer and absolute cost advantages can be gained. The best emerging industries to enter have structures that allow a firm to achieve above-average returns and create a long-term defendable position. To determine if an emerging industry has these qualities, it is necessary to forecast the industry’s potential “scenarios,” or internally consistent views of how the world will look in the future, and what the industry’s size, characteristics, and competitors will subsequently be like.

**The Transition to Industry Maturity**

**Industry maturity** occurs when an industry passes from a period of rapid growth to a period of modest growth. Transition to maturity can happen at any time in an industry’s development and is critical to recognize, as it
typically signals that an important change in an industry’s competitive environment has occurred. Examples of environmental changes include more competition for market share and a decline in industry profits.

The transition into maturity is a time when firms must commit to one of the three generic strategies and introduce process innovations for smoother, more affordable manufacturing and delivery. To succeed in a period of industry maturity, firms must avoid pitfalls like giving up too easily in favor of a short-run profit, resentment and irrational reaction toward price competition and industry practices, and clinging to the excuse of “higher quality” instead of meeting aggressive pricing and marketing moves of competitors. To lead effectively in mature, competitive environments, managers must scale down their firms’ financial performance expectations and adhere more strictly to their chosen strategies.

**The strategic issue in capacity expansion is how to add capacity to further the objectives of the firm, in the hope of improving its competitive position or market share, while avoiding industry over-capacity. Undercapacity in an industry is rarely a problem, except temporarily, since it will usually attract new investment.**

**COMPETITIVE STRATEGY IN DECLINING INDUSTRIES**

A *declining industry* is one that has experienced a significant drop in unit sales over a sustained period of time. High levels of competition occur in the decline phase when there is dwindling customer demand, high exit barriers, and a volatile rivalry among competing firms. When faced with a declining industry, firms have the option to enact one of the following strategies:

- **Leadership**—Seek a market share leadership position.
- **Niche**—Create or defend a strong position in a particular segment.
- **Harvest**—Manage a controlled disinvestment, and take advantage of strengths.
- **Quick Divestment**—Liquidate the investment as early in the phase as possible.

It is important that firms try to prepare for decline as much as possible by avoiding pitfalls like a failure to recognize decline, engaging in competitor warfare, or harvesting without any clear strengths. If a firm can successfully forecast the decline phase, it can improve its position by minimizing investments and actions that could heighten exit barriers.

**COMPETITION IN GLOBAL INDUSTRIES**

A global industry can be a source of competitive advantage to a firm when the cost of production in foreign sites facilitates affordable exports to other parts of the world or when it provides a firm with the opportunity to build its reputation and credibility. Conversely, a global industry may be a competitive disadvantage to a firm when the following factors are in place:

- **Economic Impediments**. Factors that prohibit the profitability of a global industry like high transportation and storage costs and a lack of world demand.
- **Managerial Impediments**. Culturally unique marketing and distribution channels can be difficult to manage.
- **Institutional Impediments**. Local tariffs, duties, and bribery laws can dampen global competition.

**THE STRATEGIC ANALYSIS OF VERTICAL INTEGRATION**

*Vertical integration* is when technologically distinct economic processes like R&D, production, and distribution all take place within a single firm. Vertical integration can have many strategic benefits. For example, it can make
production more efficient, improve a firm's ability to differentiate itself from competitors, and even increase a firm's overall ROI. The strategic costs of vertical integration, however, can include higher exit barriers and capital requirements, dull incentives that reduce performance, and a need for different management throughout the chain. A firm must weigh its relative potential advantages against its costs before deciding to vertically integrate.

**Capacity Expansion**

*Capacity expansion* is a significant strategic decision every firm must consider at some point in time. To make an effective capacity expansion decision, Porter recommends for firms to follow these seven steps:

1. Determine the options for the size and type of capacity additions.
2. Assess probable future additions' demands and costs.
3. Assess probable technological changes and the likelihood of additions' obsolescence.
4. Predict the capacity additions of each competitor based on the competitor's expectations about the industry.
5. Determine the industry's supply-and-demand balance and resulting industry prices and costs.
6. Determine expected market returns from the capacity addition.
7. Test the analysis for consistency.

Many firms, especially those in the commodity business, have a tendency to overbuild. The risks of overbuilding can be severe if factors like the following are in place: significant exit barriers that prevent excess capacity from leaving the market, high levels of competition, and government policies that encourage overinvestment.

**Entry into New Businesses**

According to Porter, entering a new industry is not easy—even when a business is well managed and the industry environment is favorable. Firms considering entry into new businesses must therefore carefully consider the viability of the following strategies:

- **Internal development.** This approach involves the creation of an entirely new business entity in an industry. The best industries for internal development are those in disequilibrium and those where retaliation is unlikely. To facilitate the success of internal development, firms can find a way to produce products at lower cost than incumbents, offer superior products, or cater to new market segments.

- **Acquisition.** The strategy of entering a market by buying an incumbent firm is profitable if:
  1. The incumbent's cost of keeping the business is low.
  2. The market for companies is imperfect and does not eliminate above-average returns through the bidding process.
  3. The buyer has the unique ability to operate the acquired business.

The economics of entry rests on some fundamental market forces that are operating whenever entry occurs.
FEATURES OF THE BOOK

Estimated Reading Time: 7–8 hours, 397 pages

In Competitive Strategy, Michael E. Porter reveals how a company of any size can conduct a thorough analysis of its industry to develop a strategy to improve its position among competitors. Porter breaks down the structures that comprise industry competition along with the tools and techniques companies can use to overcome competition and gain profitability. Competitive Strategy is an ideal read for executives and entrepreneurs. The chapters are best read in order.

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Michael E. Porter, one of the world’s leading authorities on competitive strategy and international competitiveness, is the C. Roland Christensen Professor of Business Administration at the Harvard Business School. In 1983, Professor Porter was appointed to President Reagan’s Commission on Industrial Competitiveness, the initiative that triggered the competitiveness debate in America. He serves as an advisor to heads of state, governors, and CEOs throughout the world. The recipient of the Wells Prize in Economics, the Adam Smith Award, three McKinsey Awards, and honorary doctorates from the Stockholm School of Economics and six other universities, Porter is the author of 14 books, among them Competitive Advantage, The Competitive Advantage of Nations, and Cases in Competitive Strategy, all published by the Free Press. He lives in Brookline, Massachusetts.