

Strategic Management

Chapter 4

# Analyzing the Market Environment

# outline

- Market environment in process
- Market
- Market structures
- Competitive behavior
- Segmentation
- Life cycle
- Portfolio models
- Strategic groups

# Part of the process

- Part of the “analysis” step

# What is a market?

- Is it a shopping mall?
- Markets exist for goods that are bought (and hence sold)
  - Markets determine prices
- Thus managers need to understand markets
  - (not least to understand how pricing works!)

# Demand factors

- You have a demand curve
  - Downward sloping
  - Shows the relationship between *quantity demanded* at different *prices*.
    - Why is it downward sloping?
    - What happens when demand increases?
    - What happens when price increase?
- Applied questions
  - How can you show greater consumer loyalty?
  - What is a desired effect of increased market expenditure?

# Market size

- Affected by
  - Product life cycle
  - Business cycle
  - Exogenous shocks
  - GNP elasticity
  - Exchange rates

# Supply factors

- You have a supply curve
  - Upward sloping
  - Shifts in curve vs. movement along curve

# Prices

- Intersection of demand and supply curves
  - Why?
- The equilibrium price
  - But don't prices always change?
    - Concept is still useful for managers!
- If supply or demand changes, prices change
  - elasticity of demand can influence degree of change



### Exercise 4.1

The shipping industry is characterised by very large variations from year to year in the price of vessels.

1. Explain this in terms of the shape of the demand and supply curves in the industry.
2. What strategic implication would you draw from the analysis?
3. Would your answer be improved by having detailed data on the shipping business available?

# Barriers to entry

- Even if you are a successful company, you have to worry about future competition
- Barriers prevent/retard future entry by new entrants
- Two types
  - Structural
  - Strategic

# Structural barriers

- Capital requirements
- Sunk costs
- Size of the markets
- Control by legislation
- Economies of scale
- Experience effect

# Strategic barriers

- Reputation
- Pricing
- Access to distribution channels
- Real benefits can be exaggerated
  - Competition cannot be avoided in the long run
  - May be illegal (anti-trust)

## Exercise 4.2

The grocery business in the UK was dominated for years during the 1990s by the major chains including Tesco, Sainsbury, Asda and Safeway. There were complaints by consumer groups that supermarket prices in the UK were higher than in the rest of Europe and that supermarket profitability was higher in the UK. For some time there was a threat of entry by WalMart, which is by far the biggest US discount retailer. WalMart offers a very wide range of products at relatively low prices. It has achieved this by building up a highly efficient world wide distribution network and it focuses entirely on attracting shoppers by offering low prices. The UK incumbent companies offered a range of additional services, such as loyalty cards, fresh food, financial services and in-store customer services. There are high start up costs for new supermarkets in the UK, starting with the process of obtaining planning permission, through constructing large out of town premises, car parks and access roads. Furthermore, UK shoppers were all familiar with the existing supermarket names, very few, however, having heard of WalMart.

In June 1999 WalMart made a bid for Asda, the UK's third largest food retailer. Assess the extent of the barriers to entering the UK facing WalMart prior to its take over of Asda.

# Market structures

- Perfect competition
  - the product is homogeneous
  - there are no barriers to entry
  - no economies of scale exist
  - there is universal availability of information on prices and quantities
  - there is a large number of competitors
- Effect
  - No firm can charge other than market price
  - Demand curve is completely flat

- Perfect competition may not seem realistic
  - But as a model it is quite useful
    - PC's became (almost) commoditized
  - |                             |   |
|-----------------------------|---|
| homogenous product          | computers identical                                 |
| no barriers to entry        | computer parts freely available                     |
| no economies of scale       | pure assembly operations have limited scale effects |
| universal information       | computer magazines etc                              |
| large number of competitors | many brands of personal computers appeared          |

- What were computer manufacturers to do?
  - PC making was no longer “profitable”
    - IBM lost its leadership
  - Differentiation?
    - Target a specific group
  - What did the different pc manufacturers do?



# monopoly

- Monopoly's demand curve is the industry's demand curve
  - Company is not a price taker, so demand curve is downward sloping
  - Monopolistic competition shifts the demand curve
    - Monopoly then tries differentiation (or barriers to entry)

# oligopoly

- When there are a few competitors, the firm needs to consider the the demand curve of every competitor
- Curve with a kink
  - Prices cannot be increased
  - Price decrease sharply reduces profits
  - The idea of the kinked demand curve has an important strategic implication for pricing: *if it is thought that the demand curve is kinked, it follows that it is necessary to make a significant price change and stick with it.*
  -

### Exercise 4.3

In Exercise 4.2 the barriers to entry to the supermarket business were assessed. The grocery business in the UK has evolved from fifty years ago, when there were many thousands of small shops, to about twenty years ago when town centre supermarkets grew up, to now when the market is dominated by the huge out of town mega stores. Track these changes over time using the different forms of market structure.

# Competitive behavior

- Firms will not behave in a passive manner
  - Firms will behave in a strategic manner
- (not least because managers practice strategic management!)

# Game theory

- Zero sum game
  - One player's gain is the other's loss
  - Sharing mature market is a good example
    - Effect of price war: lose-lose :(
- Prisoner's dilemma
  - Two players
  - silent/confess are strategies
  - Business world applications...many, many
    - Price war, advertisement, production, etc.

- Trust, reputation, dominant strategy, etc. in prisoner's dilemma model
- Game theory is highly mathematical
  - Provides important insights into behavior

# pricing

- Can be a competitive tool
- Short term revenue flows may be sacrificed as the result of cutting price in the pursuit of wider strategic objectives

- Price leadership
  - Dominant firm leads in pricing
  - Bound to be fragile when conditions are changing
- Limit pricing
  - Erect an entry barrier by charging a low price
  - Book says it's not credible
    - Others say it is!
- Predatory pricing
  - Setting a price to squeeze others out of market



- These approaches to competitive pricing are typically encountered in textbooks, but they are rarely found in practice.

# Contestable markets

- Entry costs are not sunk and exit can be achieved costlessly
  - A perfect contestable market never offers the incumbent more than the normal rate of profit
    - Limit pricing becomes essential
    - Many monopoly firms do not make monopoly type profits

#### Exercise 4.4

It is probably impossible to observe a game in practice, in the form outlined by the prisoner's dilemma, and it is unlikely that the three forms of pricing described occur in practice; furthermore, while contestable markets are probably real enough, it is difficult to point to a particular market and describe it as contestable in the theoretical sense. Despite these reservations, attempt to apply the above ideas to the example outlined in Exercise 4.2.

# segmentation

- Consumers are not all similar
  - Incomes, for example
- Many different demand curves can exist for the same product
- Objective in segmentation
  - Identify different groups
  - Estimate how each will react
  - Design marketing accordingly

- Four main characteristics which a segment needs to have it's to be exploitable
  - Identifiable
  - Demand related, e.g. wtp
  - Adequate size
  - Attainable

For example, before launching the Lexus motor car the makers had to be convinced that they could reach high income individuals in sufficient numbers; given the fierce competition which already existed among high profile brands such as Jaguar, Mercedes and BMW in the segment this was a formidable undertaking.

# Steps of segmentation

- Identify the most important segmentation variables
  - Markets are individual
  - Nonetheless
    - First identify key product characteristics, then derive characteristics of the target segment, and then finally identify the location (income, geography, social class) of the target segment;
- Construct a segmentation matrix
  - P. 84

- Analyze segment attractiveness
  - Example on p. 84
- Identify the success factors
  - Example on p. 84

# Product differentiation

- In some case, characteristics of product can be changed for differentiation
  - Cars: sports cars, SUV's, etc.
- Differentiation can be only apparent, not real
  - All paracetamol have the same formula
    - BUT the “product” can *still* be different
- Success of product can depend on
  - Price
  - Degree of differentiation



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- Model is useful for
  - Remediating problems
  - Identifying launch strategies

# Product quality

- Quality can be a dimension for differentiation
  - Products often differ only marginally
  - What is meant by quality?
    - Reliability?
    - Fanciness?
  - True quality vs. visible quality
  - Product based quality
    - Concorde vs. first class
  - Optimal quality levels

# Pricing in segments

- Monopoly will charge different prices in different markets
  - Discriminatory pricing
  - Why?
  - How?
- Step 1 research markets (segmenting, demand)
- Step 2 modify products
- Step 3 price products

- Exercise 4.5

# Life cycle

- Businesses are actually quite dynamic
  - Most tools presented so far are static
- Businesses go through stages
  - Introduction, growth, maturity, decline
- Life cycles are shortening
  - Think of cell phones

# Strategies for life cycles

- Introduction phase
  - High marketing expense (or not)
  - Continued R&D
  - Continued setup expenses
- Growth
  - Capacity has to be increased before demand
  - Threat of new entrants
  - Aggression may be necessary though complacency may be tempting

- Maturity phase
  - Attention turned to protecting market share
  - Marketing expenditure can be reduced
  - Pricing does not necessarily have to be reduced
- Decline
  - Exit?
  - Phase out production?
- Page 97,

# BCG matrix

- Relative market share vs. industry life cycle
- Relative market share is important because of its effects on
  - Scale economies
  - Experience effect
- Result is the following
  - The dog (low MS, low growth)
  - Question mark (low MS, high growth)
  - Cash cow (low growth, high MS)
  - Star (high growth, high MS)



- Dog
  - Is not necessarily unprofitable
  - Efficient running
- Cash cow
  - Achieves higher economies of scale
  - Better position than competitors
- The star
  - High costs (marketing, production, capital, inventory)
  - Maintain market share to eventually become cash cow

- Question mark
  - Will either become a star
  - Or it will become a dog

# Growth vs. Sector

- Penetration *same market; same product*
  - BMW bought Rolls Royce
- Product replacement *same market; new product*
  - BMW making “SUV” (x series)
- Market Development *new market; same product*
  - Daewoo selling cars in Britain from 1990's
- Diversification *new market, new product*
  -

- Exercise 4.7 homework
  - (pp 104—105)

# Strategic groups

- Helps to identify competitors
- Many variables
  - Organization: scale, degree of Vertical integration, etc.
  - Product characteristics: quality, image, etc.
  - Financial structure: ROA

# Example of strategic group mapping

- Specialization vs. quality for ethnic restaurants
- Exercise 4.8

# Structural analysis of industries

- Competitive forces
- Five forces
  - Threat of new entrants
  - Threat of substitutes
  - Suppliers' bargaining power
  - Buyers' bargaining power
  - Industry competitors' rivalry

# rivalry

- Clearly, rivalry depends on market structure
  - Oligopoly, monopoly, competition, etc.
- But additional insights from considering life-cycle
  - Introduction (L) , growth (H) , transition (H) , maturity (L) , decline (H)



# New entrants

- Economies of scale
- Regulation
- Entry price
- Technological factors

Competitive force

Company 1 Company 2

Threat of new entrants

High Low

Threat of substitutes

High Low

Bargaining power of suppliers

Low High

Bargaining power of buyers

Low High

Industry rivalry

Low High

# Criticisms of Porter's five forces

- Gives impression that all forces are equally important
- Focuses on threats, whereas many firms focus on coalitions
- Does not elaborate on internal issues