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SKU: 9781266006883-SOLUTIONS

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Chapter 2
Analyzing the External Environment of the Firm: Creating Competitive Advantages

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Chapter 2

Analyzing the External Environment of the Firm:

Creating Competitive Advantages

Summary/Objectives

PowerPoint Slide 2: Learning Objectives
PowerPoint Slide 3: Looking Ahead

The purpose of this chapter is to familiarize students with techniques for evaluating a firm's external environment. This chapter focuses on the value managers add when they have a sense of events outside the company. By focusing on external events, managers are able to stay a step ahead of competitors by accurately anticipating and promptly responding to actions that can impact the organization. The chapter is organized into three sections.

1. The environmentally aware organization. Emphasize that managers use scanning, monitoring, and competitive intelligence to develop forecasts. Also, the role of scenario planning is discussed.

2. The influence of the six broad segments (demographic, sociocultural, political/legal, technological, economic, global) of the general environment of the firm.

3. The role of the competitive (also called the task or industry) environment and its analysis through the application of Porter's five-forces model. We address how industry and competitive practices are being affected by digital technologies. We also address the concept of strategic groups. Managers use strategic groups to identify who its main competitors are and how a company fits in with the overall industry in which it competes.

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Lecture/Discussion Outline

We lead off the chapter with the opening case of Airbus in LEARNING FROM MISTAKES. Here's a firm that had a different vision of how to exploit an opportunity than its closest competitor, Boeing. Airbus did misjudge this particular market opportunity. Ask:

> ***Discussion Question 1:*** *Given that it is difficult to predict future market needs and trends in industries with long product life-cycles (such as jetliners), how should managers deal with this uncertainty?*

Response guidelines: Students should understand that effective strategy is often an opportunity-driven process, meaning effective strategy starts with identifying changes in the environment. Airbus saw a market opportunity for extra-large jumbo jets and focused on "perks" (such bars and beauty salons) while Boeing saw a market opportunity for smaller jumbo jets and

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focused on efficiency and comfort. While both companies made a bet on an uncertain future, Boeing better predicted the needs of customers and airlines. Specifically, filling a large A380 with passengers is a daunting task for airlines, while filling a fuel-efficient Boeing Dreamliner is much more manageable for airlines. Students should understand that it is not only the end-consumer that determines the success of a product or service (passengers loved the A380) but also the service providers (airlines) must be able to operate the airliner effectively and efficiently. Companies must therefore consider a broad range of important stakeholders and use effective strategy tools (such as the tools we introduce in Chapter 2) to predict changes in the general and competitive environment. Students should also realize that strategic analysis of the general and competitive environment becomes increasingly important when the life-cycle of the product or service is very long as changes or adjustment become infeasible.

Discussion Question 2: *How should Airbus compete against Boeing going forward?*

Response guidelines: Students may come up with a few intriguing suggestions. After they do, instructors may want to group the responses into external and internal categories. It is expected that some students focus on perceived internal strengths and weaknesses (such as improving Airbus' R&D competence) while others focus on opportunities (such as investing in the market for short-haul airplanes or space travel). The instructor should illustrate that competition between two large (and in many aspects similar) competitors is often driven by taking a position and seize external opportunities effectively.

Of course, taking a position is uncertain and risky (as we saw with the A380) so the key is not to avoid uncertainty and risk, but to manage it effectively (with the tools we introduce in Chapter 2). The instructor may also point out that if executives want certainty and clarity, they can just wait for other firms to take a position and see how they do. Then they will know what works, but it will be too late to profit from the knowledge.

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I. Enhancing Awareness of the External Environment

PowerPoint Slide 4: The Importance of External Environment
PowerPoint Slide 5: Enhancing Awareness of the External Environment
PowerPoint Slide 6: Environmental Scanning and Monitoring
PowerPoint Slide 7: Competitive Intelligence
PowerPoint Slide 8: Environmental Forecasting
PowerPoint Slide 9: SWOT Analysis

We address three important processes—scanning, monitoring, and gathering competitive intelligence—which managers use to develop environmental forecasts. EXHIBIT 2.1 depicts relationships among these activities. Also, we address scenario analysis and its role in anticipating future major changes in the external environment as well as the role of SWOT analysis.

We lead off the section with a discussion of Ram Charan's concept of "perceptual acuity"—the ability to sense what is coming before the fog clears. We give three examples of what three CEOs have done to improve their perceptual acuity: met with key managers

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periodically to discuss what is going on, met with the CEOs of other organizations four times a year, and asked outsiders to critique their firm's strategy.

> ***Teaching Tip:*** *Most students in your class will not likely be CEOs or top executives. So, one way to help them apply this idea is to ask them how they could apply it in their present position—or in a job to which they immediately aspire. Hopefully, they will come up with ideas such as spending time with people in their organization to address issues outside of their immediate job, describing how their efforts affect other areas/departments in the firm, and seeking perspectives of colleagues and friends who work in a different organization. The key point, of course, is to encourage them to look at issues from a broader perspective instead of focusing on their immediate work responsibilities.*

A. The Role of Scanning, Monitoring, Competitive Intelligence, and Forecasting

1. Environmental Scanning

Environmental scanning involves surveillance of the firm's external environment to predict environmental changes to come and detect changes that are already underway. We discuss the example of how Procter & Gamble, with its wide range of household products, can be a good barometer of household spending.

> ***Discussion Question 3:*** *Would these "tips" be equally appropriate for all industries? Why? Why not?*

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> ***Discussion Question 4:*** *Could such an approach be used in other industries? What investments would be required?*

Environmental scanning can also involve obtaining information from your customer base. The SUPPLEMENT below provides an example of how this was effectively used by an online contact-lens retailer, Coastal Contacts.

Extra Example: Ask Your Customers for Ideas

Coastal Contacts, one of the largest online contact-lens retailers in North America, came out of its two-day planning session with few ideas about how to spur growth. Thus, over the next six months CEO Roger Hardy and his senior team called customers each week to see whether they had any ideas. To the company's surprise, one recurring theme emerged—customers wanted to get their lenses the next day. "We started overnighting everything," he reports. Sales in the U.S., where he recently made the change, were up 41 percent for the year, bringing company sales to $155 million.

Source: Harnish, V. 2011. Five ways to get your strategy right. *Fortune*. April 11: 42.

> ***Discussion Question 5:*** *What are some other examples of firms that got excellent ideas by simply asking their customers for input?*

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2. Environmental Monitoring

Environmental monitoring tracks the evolution of trends, events, or streams of activities in the external environment. In this section, we present some of the factors monitored by three organizations: Motel 6, Pier 1 Imports, and Johnson and Johnson Medical Products. Such factors are vital for managers in determining their firm's strategic direction and resource allocations.

The SUPPLEMENT below represents the factors that the Director of Planning of Vought Aircraft considered critical. You may initially ask the students:

Discussion Question 6: *What indicators do you believe a firm should monitor that produces both (1) weapon systems for the military, and, (2) key components for the commercial aircraft industry?*

Extra Example: Factors to Monitor—Vought Aircraft

Commercial Aircraft:

1. Oil prices
2. Age of fleet of airlines
3. Profitability of airlines

Defense Department:

1. Where weapons are in the life cycle
2. Mission requirements of the military

Source: Authors' interviews.

The SUPPLEMENT below discusses how Cisco, the networking giant, learned from its mistakes during the Internet bust in 2001—and now carefully it monitors its inventory levels. It points out that managers must monitor key aspects of the firm's internal environment—as well as the firm's external environment.

Extra Example: How Cisco Learned from Its Mistakes

In April 2001, Cisco made one of the more painful confessions of the Internet bust: It had so much networking gear piled up that it had to take a $2.5 billion write-off for equipment that it figured nobody would ever buy. It has been working hard ever since to make sure that such a thing never happens again.

Supply chain chief Angel Mendez is grilled at monthly reviews by CEO John Chambers and other top executives. Now, Cisco has half the inventory it did in 2001—even though its revenues are twice as large. Says Mendez: "It didn't take John eight years to start asking questions (about inventory levels). He asks about every eight minutes."

Source: Burrows, P. 2009. Tech: Lean and Ready to Spring. *BusinessWeek*. April 27: 14–16.

Discussion Question 7: *Are you aware of other firms that have failed to effectively monitor key aspects of their internal environment (e.g., excessive numbers of employees and layers of management; high levels of inventory that became obsolescent; insufficient sales, marketing, engineers, etc. to meet increasing demand for goods/services and innovations, etc.)?*

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The SUPPLEMENT below discusses why Caterpillar may serve as a macroeconomic early-warning system.

Extra Example: Caterpillar—A Macroeconomic Early-Warning System?

Although it is hard to confuse a 40-ton excavator with a crystal ball, forecasters could do worse than tracking retail sales of the huge, yellow machines sold by Caterpillar Inc. Being the largest seller of equipment used to build stuff or extract the stuff from the ground used to build that stuff, Caterpillar's customers' appetite is sort of a macroeconomic early-warning system.

Two big worries—the slowdown in China's property market and a related slump in demand for commodities from crude oil to iron ore—show up quickly in its monthly sales reports, helpfully broken down by region and type of machinery.

The year 2014 has, not surprisingly, been a tough year for the firm's shareholders. Its stock price trailed the S&P 500 by 31 percent.

Source: Jakab, S. 2015. Caterpillar is stuck in its cocoon. *Wall Street Journal*. April 23: C1.

3. Competitive Intelligence

Competitive intelligence helps firms define and understand their industry and identify rivals' strengths and weaknesses. Done properly, competitive intelligence helps a company to avoid surprises by effectively anticipating and responding to competitors' moves.

We briefly address the importance of competitive intelligence to firms in the banking, airline, and automobile industry.

Discussion Question 8: *What are other industries where competitive intelligence is extremely important? How might such information be collected?*

We address how the Internet has accelerated the speed at which firms can find competitive intelligence.

We discuss in the text also some of the ethical guidelines that United Technologies has implemented.

Discussion Question 9: *Are you aware of ethical guidelines that other companies have developed? Were they effective? Why? Why not?*

Teaching Tip: The discussion of Competitor Intelligence provides the instructor with an opportunity to introduce the subject of ethics into the classroom. We suggest presenting scenarios that are not "black and white." For example, a firm advertises a position in order to get a chance to interview employees of a rival company with no intention to hire them. While this may not be illegal, clearly it is difficult to justify morally. The ensuing discussion will help to clarify the distinction between illegal and unethical behavior.

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4. Environmental Forecasting

Environmental scanning, monitoring, and competitive intelligence are important inputs for analyzing the external environment. However, they are of little use unless they provide raw material that is accurate enough to help managers make accurate forecasts.

We address the twin problems of either assuming that the world is certain and open to precise predictions, or the assumption that it is uncertain and totally unpredictable. And, we provide the famous example of poor forecasting by Digital Equipment Corp., which caused it to ignore the potential of personal computers. We also provide several other predictions about the future of technology which did not pan out.

Discussion Question 10: *What are some other errors in forecasting with which you are familiar?*

It should be interesting to ask students to provide a few more examples of technology forecasts that really missed the mark—some of them go farther back in time than the ones listed in the text. A few of them are listed in the SUPPLEMENT below.

You might even ask them what forecasts/predictions for the future of technology that they have.

Extra Example: Technology Forecasts That Missed the Mark

1946: "Television won't be able to hold on to any market it captures after the first six months. People will soon get tired of staring at a plywood box every night." —20th Century Fox Studio executive Darryl Zanuck

1959: "Before man reaches the moon, your mail will be delivered within hours from New York to Australia by guided missiles. We stand on the threshold of rocket mail."—U.S. Postmaster General Arthur Summerfield

1961: "There is practically no chance communications space satellites will be used to provide better telephone, telegraph, television, or radio service inside the United States."—Federal Communications Commission (FCC) commissioner T.A.M. Craven

1966: "Remote shopping, while entirely feasible, will flop." —*Time Magazine*

Source: Dunn, M. 2016. 20 tech predictions that failed. *www.news.com.au*. March 8: np.

The SUPPLEMENT below provides an intriguing example for the importance of forecasting trends in the general environment.

Extra Example: Focusing on what most businesses do is a big mistake

When analyzing the general environment, strategists are well advised to focus on the long-term future rather than the present. Strategies that disregard this advice are often destined to underdeliver. It is easy to understand why companies may base their strategy on the present: It is easy to understand and presents little uncertainty. Yet, focusing on the present is like developing a strategy based on what you see in a rearview mirror. If you develop a strategy this way, you implicitly assume that the future will look like the present. Yet, this may only be true in very static industries. The majority of industries are increasingly dynamic and change is the rule rather than the

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exception. For instance, at one point, most movies were rented on something physical (like VHS or DVD), yet the growth was in "new" distribution channels such as streaming. Companies that do not focus on the small but growing market may quickly become a "dead man walking".

Andrew Winston, the founder of Winston Eco-Strategies and an adviser to leading companies, highlights that this advice is particularly important when companies try to forecast environmental and social issues. It is easy to understand current environmental conditions but developing business models on what most companies do in the environmental space likely leaves opportunities on the table. Take Amazon for example. While many delivery companies presently rely on conventional delivery trucks, Amazon aggressively replaces its delivery trucks fleet with electric delivery vans from Rivian to achieve its goal to be carbon neutral by 2040. Focusing on the future of general environmental factors will likely give companies a first mover advantage.

Sources: Winston, A. 2018. Focusing on what 90% of businesses do now is a big mistake. *MIT Sloan Management Review*, 59(3): 80–84.

5. Scenario Analysis

Scenario analysis provides a set of tools that enable managers to imagine threats and opportunities the future may bring. As a general rule, scenarios should be used by businesses whose external environments are prone to fundamental or sudden change and whose anticipation of such change is of vital strategic importance.

It is important to note that scenario analysis draws on a wide range of disciplines and interests, among them economics, psychology, sociology, and demographics.

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Discussion Question 11: *Why must scenario analysis and scenario planning draw on a variety of disciplines and interests?*

We provide an example of how PPG Industries has benefited from the use of scenario analysis and planning.

We address the value of a firm in creating an environmentally aware organization—which includes environmental scanning and monitoring, as well as competitive intelligence, forecasting, and scenario planning. In contrast, the late Steve Jobs (Apple's former Chairman) took a far different approach to determining what customers *really* wanted. We discuss Jobs' distaste for sophisticated approaches to market research.

Discussion Question 12: *Would such a mindset work for other organizations? Why? Why not? (Firms in commodity industries—which experience much less uncertainty than technology industries have less need for such "intuition" since these industries face much less dramatic change in market demand and technologies. And, of course, very few firms have the visionary genius of a Steve Jobs! Also, you might point out how Ron Johnson (who was fired as CEO of J.C. Penney in early April 2013) relied too much on his intuition and drove the firm into the ground—and almost into bankruptcy.*

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B. SWOT Analysis

We briefly address SWOT Analysis at this point. SWOT stands for strengths, weaknesses, opportunities, and threats. SWOT analysis provides a framework for analyzing these four elements of a company's internal and external environment.

It is important to note that SWOT analysis provides the "raw material," that is, a basic listing of conditions and factors inside and outside of a company.

> ***Discussion Question 13:*** *What do you consider to be some of the major advantages and disadvantages of SWOT analysis? (This issue is addressed in more detail in Chapter 3, but you should point out that a key disadvantage is that strengths may not necessarily convert to sources of competitive advantage that are sustainable in the marketplace.)*

II. The General Environment

PowerPoint Slide 11: The General Environment
PowerPoint Slide 12: The Demographic Segment
PowerPoint Slide 13: The Social Segment
PowerPoint Slide 14: The Political/Legal Segment
PowerPoint Slide 15: The Technological Segment
PowerPoint Slide 16: The Economic Segment
PowerPoint Slide 17: The Global Segment
PowerPoint Slide 18: General Environment: Relationships among Elements

The general environment consists of factors that can have a dramatic effect on a firm's strategy. Typically, a firm has little ability to predict trends and events in the general environment, and even less ability to control them.

We divide the general environment into six segments: demographic, sociocultural, political/legal, technological, economic, and global.

EXHIBIT 2.2 provides examples of key trends and events in each of the six segments of the general environment

> ***Discussion Question 14:*** *How will the factors in Exhibit 2.3 affect specific industries?*
>
> ***Discussion Question 15:*** *Which factors are more difficult to predict than others? (e.g., macroeconomic changes are typically more difficult to predict than demographic changes)*
>
> ***Discussion Question 16:*** *How are these factors interrelated?*
>
> ***Discussion Question 17:*** *What factors that are not listed in this exhibit do you feel are important?*

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A. The Demographic Segment

Demographics are the most easily understood and quantifiable elements of the general environment. Demographics include elements such as the aging population, rising or declining affluence, changes in ethnic composition, geographic distribution of the population, and income level disparities.

Discussion Question 18: *What are the implications of ethnic diversity for the work place?*

Discussion Question 19: *What implications does the migration to the South and West in the United States have for individual businesses?*

Discussion Question 20: *How does the "graying of America" affect U. S. companies?*

Among the trends we discuss are the aging of the population and how it may differentially affect a wide variety of industries. We also discuss the increasing number of older Americans and its importance for attracting and retaining older workers.

Ask:

Discussion Question 21: *It might be interesting to ask what the implications (of the aging of the population) are for today's organization (e.g., how can firms attract and retain older workers, changes in financial and non-financial incentives, etc.) as well as for public policy (e.g., changes in tax policies, increasing the number of immigrants, etc.).*

We also provide INSIGHTS FROM RESEARCH: New Tricks: Research Debunks Myths about Older Workers (in text, The General Environment section). Here, results from a meta-analysis points out some findings about older workers many people would find counterintuitive. The findings concluded older workers are NOT less motivated, more resistant to change, less trusting, less healthy, or more valuable to work-family issues. The only "myth" supported by the data was older workers are less willing to participate in training and career development.

Discussion Question 22: *What are the practical implications of these findings*

As noted in the IFR: provide more opportunities for younger and older workers to work together; promote positive attributes of older workers; and, engage employees in open discussions about stereotypes. The broader learning point would be to encourage students to always question their assumption bases—they might be wrong, at times!

B. The Sociocultural Segment

Sociocultural forces influence the values, beliefs, and lifestyles of a society. Examples include a higher percentage of women in the workforce, dual-income families, increases in the

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number of temporary workers, greater concern for healthy diets and physical fitness, greater interest in the environment, and families postponing having children.

> ***Discussion Question 23:*** *Name two industries that have benefited from the growing awareness about health and fitness. Also name two that have been adversely affected by this trend.*

> ***Discussion Question 24:*** *What must firms do to attract and retain women employees? Why are such efforts becoming increasingly important?*

The section also addresses how values and beliefs shaped changes in consumer preferences. Traditionally, values and beliefs affect the demand for *types* of products (e.g., more environmentally friendly products), but values and beliefs may also influence the *amount* of products and services customers demand. Younger generations often have different attitudes towards owning products, leading to more cautious and frugal consumer spending.

Ask:

> ***Discussion Question 25:*** *Can you think of an industry that may need to respond to the values and beliefs (such as environmental concerns and product ownership) of younger customers?*

The SUPPLEMENT below provides some perspective on the consumer preferences of the Generation Z.

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Extra Example: Consumer Preferences of the Gen Z

Consumers of the Generation Z (born in the mid-1990s and early-2000s) are about to become the most sought-after target market in countries around the world. However, these consumers may be more frugal than earlier generations because their early life experiences shaped their values and beliefs when it comes to consuming. Specifically, kids of the Gen Z experienced economic downturns or saw their parents struggle during recessions (such as the global financial crisis of 2008). These early life experiences have shaped the consumer attitudes of Gen Z consumers and imprinted a thrifty attitude.

For example, Japan had five recessions in the past 20 years, transforming Japanese consumers into one of the most frugal consumers in the world. These frugal attitudes learned at a young age also persist and hardly change when economic conditions brighten. In Japan, recent economic conditions are more positive and wages are growing. Fast Retailing Co. (the owner of the fashion company Uniqlo), for instance, is raising entry level pay by 20% to win the war for talent in the tight Japanese labor market. However, young Japanese are not increasing their spending, but stick to buying necessities.

Executives around the world adjust their strategies to effectively address frugal consumer attitudes and broader preferences for sustainable consumption. For instance, fashion company "Urban Outfitters" recently started a subscription clothing rental business called Nuuly. For a fee of $88 dollars per month, consumers get six clothing pieces, a reusable bag, and a prepaid return envelope to return the clothes (or pay full price in case you love and want to keep them). The hope is that young consumers will find this new clothing business model not only attractive for its reduced environmental impact but also for meeting the broader values of beliefs regarding product ownership of Gen Z consumers.

Sources: Du, L., & Milligan, E. 2019. In regions hit by recession, Gen Z is turning out to be frugal. *Bloomberg.com*. April 25: np. Naughton, K., Dawson, C., Welch, D., & Coppola, G. 2019. Gen Zero. *Bloomberg BusinessWeek*. April 29: 18–19; Safdar, K. 2019, May 21. Urban Outfitters to start renting clothes. *Wall Street Journal*. June 21: np.

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C. The Political/Legal Segment

Political processes and legislation influence the regulations with which industries must comply. Some important elements of the political/legal arena include tort reform, the Americans with Disabilities Act (ADA), deregulation of utilities and other industries, and increases in the federally mandated minimum wage.

Discussion Question 26: *What do you see as some of the pros/cons of the Americans with Disabilities (ADA) Act?*

We close this section with a brief discussion of how legislation in the U.S. has restricted the number of H-1B visas for highly skilled professionals.

Discussion Question 27: *Should the U.S. Congress increase the number of H-1B visas? Why? Why not?)*

STRATEGY SPOTLIGHT 2.1 addresses how advocacy groups and public opinion can put pressure on companies to address environmental sustainability concerns such as waste reduction in a proactive manner.

Discussion Question 28: *What are some of the challenges associated with companies facing increasing pressure for sustainable business practices? Do you have ideas about how companies could use eco-friendly business practices and models to differentiate themselves in the market?*

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D. The Technological Segment

Developments in technology lead to new products and services and improve how they're produced and delivered to the end user. Innovations can create entirely new industries and alter existing industries.

Discussion Question 29: *Ask students to speculate on the impact of the following technologies on American industry: (1) the Internet, (2) manufacturing innovations (e.g., robotics), (3) genetic engineering/designer genes. (The last items may provoke some heated discussion regarding the ethical implications.)*

We also address a fascinating issue: some of the promising future applications of nanotechnology and how it will impact some industries.

STRATEGY SPOTLIGHT 2.2 addresses how data privacy concerns helped Apple to gain a competitive edge over its closest competitors.

The SUPPLEMENT below discusses how SkyMall, the inflight magazine was forced into bankruptcy by technology—smartphones and tablets.

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Extra Example: It Seems That Technology Killed SkyMall

The firm behind the inflight catalog, SkyMall, filed for bankruptcy protection. It is clearly a victim of evolving rules and technology that now permit airline passengers to keep their smartphones and tablets powered up during flights.

For 25 years it sold quirky products like a Darth Vader toaster or a paper-towel holder with USB ports. However, SkyMall is now seeking a court supervised sale of its assets, according to papers filed on January 22, 2015 with the Phoenix Bankruptcy Court.

CEO Scott Wiley cited a "crowded, rapidly evolving and intensely competitive" retail environment as the reason for the firm's recent struggles. And, he said, "With the increased use of electronic devices on planes, fewer people browsed the SkyMall inflight catalog."

SkyMall had revenue of $33.7 million in 2013. But, its sales sank to only 15.8 million for the nine months ending on September 28, 2014.

Source: Corrigan, T. 2015. SkyMall Succumbs to a New Jet Age. *Wall Street Journal*. January 24–25: B3.

Discussion Question 30: *Are you aware of other cases where technology is a key factor that is reshaping—or adversely affecting—an industry? What industries are most likely to be influenced by technological changes?*

E. The Economic Segment

The economy has an impact on all industries, from suppliers of raw materials to manufacturers of finished goods and services, as well as all organizations in the service, wholesale, retail, government, and nonprofit sectors of economies. Key indicators include interest rates, unemployment rates, the consumer price index (CPI), the Gross Domestic Product (GDP), and net disposable income.

Discussion Question 31: *Compare the impact of rising (or declining) interest rates on the overall demand for the following industries: (1) housing (will have a significant impact), (2) automobiles (will have a significant impact), (3) fast food (will have very little effect).*

F. The Global Segment

Globalization provides both opportunities to access larger potential markets and a broad base of factors of production such as raw materials, labor, skilled managers, and technical professionals. However, such endeavors carry many political, social, and economic risks. Examples of important elements in the global segment include currency exchange rates, increasing global trade, the economic emergence of India, and China's admittance to the World Trade Organization.

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Discussion Question 32: *Provide examples of firms that have succeeded (stumbled) in their efforts to expand into international markets. What factors can explain their success (failure)?*

We also address the rising middle class in emerging countries and how it has led to increased employment in those countries by multinationals.

Discussion Question 33: What are the risks associated with accessing a larger potential market overseas as a result of the process of globalization? Do the risks of globalization outweigh its benefits?

G. Relationships among Elements of the General Environment

In our discussion of the general environment, we have addressed many relationships among the various elements.

EXHIBIT 2.3 provides many examples of how the impact of trends or events in the general environment can vary across industries.

The SUPPLEMENT below provides some insights on how many elements of the General Environment are interrelated. It is a rather interesting context—Cairo, Egypt after the Arab Spring.

Extra Example: Entrepreneurship in Cairo after the Arab Spring

A different type of grassroots revolution has begun in the aftermath of the Arab Spring. According to Ramez Mohamed, CEO of Flat6Labs, a Cairo-based startup accelerator, entrepreneurship has thrived over the past two years. He contends that Egypt's youth feel empowered to make a difference, one venture at a time.

Here are some of his firm's most promising startups and the opportunity that they are tackling:

- **Ekshef**: With an Arabic-only platform and Yelp-like rating system, the service enables Egyptians to search, review, and recommend doctors from the directory. *Opportunity:* The country has more than 75,000 health care clinics, but it is hard for patients to find the right physician.
- **Nafham**: The service condenses the country's public-school curriculum into online, crowdsourced lessons. Users can vote up or down based on quality. Its staff also produces video content. *Opportunity:* Egypt's rising population is putting a squeeze on classroom space.
- **Eshtery:** The utility lets users shop by scanning codes on signs around town and having the items delivered to them. The business was inspired by Home Plus, a supermarket that offers a similar service in South Korea. *Opportunity:* It is hard to buy groceries if you work two hours from the market.
- **Ogra:** A mobile app, a la Uber, which connects passengers with reliable drivers. *Opportunity:* With social tensions spilling onto the street, public transportation that is dependable is hard to find.

Source: Anonymous. 2013. Emerging tech scene: Cairo. *Fast Company*. March: 31.

The "Digital Economy" is an important aspect of an effective strategy. We introduce the topic and provide examples of how it can be applied in practice. Specifically, corporations are increasingly collecting and analyzing data on their customers, including data on customer characteristics, purchasing patterns, employee productivity, and physical asset utilization. Such efforts have the potential to help firms better customize their product and service offerings to

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customers as well as more efficiently use the resources of the company. We provide examples of Pepsi and Kaiser Permanente as well as some figures on how its use has dramatically increased in recent years—as well as how it can improve a firm's performance.

STRATEGY SPOTLIGHT 2.3 provides an example of how the short-video app TikTok uses AI to create successful digital offerings.

Discussion Question 34: *How can firms effectively use AI to improve their competitive position? What other products or services may also benefit from the use of AI?*

III. The Competitive Environment

PowerPoint Slide 19: Digital Economy, A Fundamental Shift in the Business Environment
PowerPoint Slide 20: The Competitive Environment
PowerPoint Slide 21: Porter's Five Forces Model of Industry Competition
PowerPoint Slide 22: The Threat of New Entrants
PowerPoint Slide 24: The Bargaining Power of Buyers
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PowerPoint Slide 31: Strategy Groups within Industries
PowerPoint Slide 32: Strategy Groups as an Analytic Tool
PowerPoint Slide 33: Example: Strategic Groups within Industries

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Here, we draw upon a well-known analytic tool, Michael Porter's five-forces model of industry competition. We introduce this model and discuss examples of each force. We then address the strategic groups concept and its implications for studying rivalry and competition.

A. Porter's Five-Forces Model of Industry Competition

EXHIBIT 2.4 illustrates Porter's five-forces model of industry competition

When introducing this model, it is useful to show how the model provides insight into an industry's dynamics and expected profit levels. The SUPPLEMENT below provides such an analysis on the paint and allied products industry. The analysis is restricted to the trade sales (i.e., house paint) segment of the industry. The competitive forces are very different for other segments such as the specialized high-tech automobile finishes.

Note: For our purposes of illustrating the "basics" of the "five forces," the analysis has been simplified. We assume buyers to be consumers, although there are, of course, other distinct groups such as hardware stores, and large discounters such as Walmart. Obviously firms' bargaining power vis-à-vis paint manufacturers vary significantly. Similarly, our analysis

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assumes the industry's products to be commodity products. However, there are exceptions, such as Olympic Stain, that have successfully differentiated their products on the basis of quality.

Extra Example: The Paint and Allied Products (PAP) Industry

An analysis of the Paints and Allied Products industry (SIC 2851), using the five-forces model, demonstrates why this industry has traditionally been caught in a price-cost squeeze and is unable to pass on rising raw material costs to its customers.

To illustrate the price-cost squeeze that this industry is facing, consider that between the years 1995 to 2000, the PPI (producer price index—the price for which it sells its output) of the PAP industry increased an average of only 2 percent. The PPI for petroleum refining and related products—a key supplier to this industry—increased at a rate of 6 percent over this same period of time. Hence the price of this key raw material was roughly twice the rate of inflation (about 3 percent); whereas, the PAP industry was lower than the rate of inflation. Thus, the PAP industry has been unable—due to unfavorable industry competitive forces—to pass on cost increases to their suppliers; thus eroding profitability.

Consider the PAP industry in terms of each of Porter's Five Forces:

Threats of Entry: Very High (minimal capital investment needed, little proprietary technology, regional firms can compete in local markets due to high transportation costs, little brand identification of existing competitors)

Buyer Power: Very High (low brand loyalty, relatively little product differentiation, relatively low switching costs)

Supplier Power: High (especially for petroleum derivative raw materials—a key input in industry)

Substitute Products: High (plastics, wood paneling, wallpaper coverings, etc.)

Rivalry: High (competition is based mostly on price competition, because of little brand loyalty and product differentiation; easy entry and exit from the industry gives rise to frequent price wars; little price leadership exhibited by larger firms)

Sources: www.bls.gov (Bureau of Labor Statistics); www.ita.doc.gov (International Trade Administration)

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It is useful to point out that there can also be very profitable opportunities to compete in industries that have overall low profits. For example, in the paint industry, Olympic Stain has typically been a very successful and highly profitable firm because they have found an attractive niche in the market and developed a differentiated product (through product development and advertising).

We also provide a brief discussion of some of the competitive forces affecting the hotel industry.

1. Threat of New Entrants

After summarizing the major barriers to entry, ask students to provide examples of industries characterized by each of these entry barriers. This may help them to understand what initially may appear to be rather complex ideas.

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We discuss the concept of "the era of Lego innovation." Here, valuable advances in technology can be attained by imaginatively combining components and software available to everyone. Clearly, this serves to lower entry barriers.

> ***Teaching Tip:*** The chapter explains how economies of scale and economies of experience (learning curve) erect significant entry barriers. In the auto industry, U.S. manufacturers such as Ford and G.M. have high economies of scale (being the large producers) and all the benefits of learning curve (having been in the business for almost a century). Despite these advantages, foreign auto producers have entered the U.S. market and have increasingly gained market share over the past few decades. Ask the students why this happened? Does this prove that the concepts we discussed are wrong? Or does it point out that additional factors have to be considered? Point out that foreign producers have the benefits of lower labor costs and/or have developed better manufacturing technologies (such as Toyota's lean manufacturing).

2. Bargaining Power of Buyers

It may be interesting to discuss when a group of buyers becomes powerful. For instance, organizations that produce "talent" (i.e., business schools) may have varying power against groups of organizations that hire business school graduates. For instance, large employers may require changes to the curriculum or shift talent production in house (see Apple University).

Moreover, Apple uses its buyer power to negotiate very low rental rates—compared to other stores—for its stores in shopping malls. This is because its powerful brand/products can help drive customers to the mall and increase overall sales in a mall by as much as 10 percent. Roughly speaking, Apple pays 2 percent of sales—compared to other tenants who may pay as much as 15 percent of sales.

Discussion Question 35: *Can you think of other tenants that would be able to negotiate low rental rates? Why?*

STRATEGY SPOTLIGHT 2.4 addresses how Nike created a "Connected Strategy" to circumvent traditional retailers, which reduced the bargaining power of one of Nike's buyer groups.

The SUPPLEMENT below explains that many huge consumer product firms are going to cut the amount of money they will spend on advertising. Clearly, this will enhance their buyer power.

Extra Example: Large Consumer Product Firms Cut Advertising Budgets

Procter & Gamble is planning to make deep cuts in its number of advertising agencies. It hopes to save up to half-a-billion dollars in fees that it now pays to outside firms to help pitch its wide variety of everyday items—from Gillette razors, to Tide detergent, to Pantene hair care, to Bounty paper towels.

Needless to say, this worries Madison Avenue. P&G is joining other companies—such as Unilever, L'Oreal SA, Coca-Cola Co, S.C. Johnson, and Visa—that are all trying to force advertisers to either lower prices or risk losing the business altogether. These firms are striving to offset slow growth with cost cuts.

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P&G CFO Jon Moeller said the household-products giant plans to "significantly simplify and reduce" the number of agencies it works with on ads, media buying, public relations, package design and in-store marketing. Similarly, Unilever, which spent about $7 billion on advertising and marketing in 2014, is currently reviewing its global media-buying business. A person familiar with the issue said the process is driven in part by the need to find "cost savings and efficiencies."

Such pressures have prompted extensive industry consolidation. For example, giants Publicis Groupe SA and Omnicom Group Inc. tried—but failed—to merge in 2014. The agencies remain at the behest of clients that are in an increasingly frugal mood.

Source: Tadena, N. & Ng, Serena, A. S. 2015. P&G Joins the Movement to Reduce Costs. *Wall Street Journal*. April 27: B1–B2.

3. Bargaining Power of Suppliers

Briefly discuss some of the conditions under which a supplier group may become powerful. The bargaining power of suppliers can be presented as the mirror opposite of the bargaining power of suppliers. For example, the relative sizes and concentrations largely determine the bargaining power of the two parties involved in the transaction.

The section discusses how catfish farmers in Mississippi increased their power by forming a cooperative—Delta Pride Catfish.

The SUPPLEMENT below discusses how hotel companies in "tight" housing markets such as San Francisco raise their profits by exploiting the limited supply of housing, highlighting potentially negative consequences of supplier power. Clearly, raising prices benefits hotel firms in the short run, but is it prudent in the long run?

Extra Example: Risk your reputation if you have strong bargaining power?

J.P. Morgan organizes one of the leading annual healthcare conference in San Francisco, which attracts thousands of attendees who are linked to 450 companies every year. It is no secret that San Francisco's housing market is one of the most expensive in the world. But that is not all. San Francisco is also famous for a lack of hotel rooms, meaning hotels operate in a seller's market. It is therefore no surprise that the arrival of around 9,000 travelers leads to exorbitant hotel rates because hotels flex their muscles and exploit their powerful supplier position. In 2018, for instance, a room at a Holiday Inn Express close to the conference venue was $527 a night. Other hospitality providers such as restaurants also join in on the high-price game. For instance, cold lunch buffets at some establishments close to the conference venue were offered for more than $70 dollars a head and came with a mandatory 25% service charge.

While these high prices are a consequence of market principles such as "supply and demand," hotels and other hospitality firms should also consider the wider consequences of excessively high prices. For instance, smaller healthcare and biotech startups may not be able to attend the conference, which may be perceived as stifling entrepreneurship. In addition, people living in close proximity to the conference venue or travelers that visit San Francisco for unrelated business reasons may protest against the high costs of hospitality services. The media may have an open ear to these outcries over high prices.

Overall, hospitality providers may expose themselves to reputational penalties if they charge the highest possible price. While these reputational penalties are likely to be lower than price gauging in events of natural disasters (e.g., Hurricane Harvey destroying much of the Houston metropolitan area in 2017), hotel chains and other hospitality providers may be well-advised to consider ways to address any potential backlash.

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Source: Grant, C. 2018. The real winners in biotech. *Wall Street Journal*. December 28: np.

4. The Threat of Substitute Products and Services

Emphasize that the viability of a substitute product depends largely on its relative price-performance trade-off, i.e., more value for the same price or the same value for a lower price. Examples are electronic security systems versus security guards, and the use of steel versus plastic for components in the manufacture of automobiles.

We discuss substitutes and give the example of how the use of teleconferencing poses a threat to the airline industry.

5. The Intensity of Rivalry among Competitors in an Industry

After discussing the factors that lead to intense rivalry in an industry, provide an example of an industry in which competition has recently been intense. For example, most students are familiar with the recurring price wars in the U. S. airline industry. Ask them to explain this using the factors discussed (e.g., undifferentiated service, low switching costs, slow industry growth, numerous competitors, etc.) You might point out that this industry was expected to report huge losses in 2001 even before the September 11, 2001 terrorist attack. Beginning in late 2005, the airlines' problems were further aggravated by extremely high fuel costs.

The SUPPLEMENT below is Michael Porter's response to a question as to whether or not he would add a "sixth force" if he were developing his framework today.

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Extra Example: Should There Be a "Sixth Force?" Michael Porter's Perspective

"There have been two nominees for the sixth force. One is government. After much further work using and teaching the framework, I have reaffirmed my original conclusion that government is not a sixth force because there is no monotonic (direct linear) relationship between the strength and influence of government and profitability of an industry. You can't say that 'government is low, industry profitability is high.' It all depends on exactly what government does. Also, there are many different parts of government, each with its own distinct impacts. And, how do you assess the consequence of what government does? Well, you look at how it affects the five forces.

"The other, more recent, candidate for a sixth force involves organizations whose products and services are complementary to the primary organization's products and services. Again, there is no monotonic relationship between the extent of complements and profitability. Sometimes having many complements is consistent with high industry profitability, sometimes with low profitability. It has to do with how complements affect the five forces.… Clearly, complements have much to do with the size of the pie, but their role in the division of the pie is independent of other factors."

Source: Argyres, N. & McGahan, A. M. 2002. An interview with Michael Porter. *Academy of Management Executive*. 16 (2): 43–52.

EXHIBIT 2.5 provides a summary of key points from the discussion of industry five-forces analysis.

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B. Using Industry Analyses: A Few Caveats

This section was written as a "caveat" to address some limitations of Porter's five-forces model. First, managers should not always avoid low profit industries. We provide the example of WellPoint Health Networks (now Anthem, Inc.).

> ***Teaching Tip:*** Even when industry analysis shows that an industry is unattractive, there are a few firms that seem to be able to earn high returns. For example, Southwest Airlines has been consistently profitable in an otherwise unattractive industry over the past several years. Does this mean that industry analysis is misleading? You may point out that industry analysis is useful to predict an industry's average profitability, but not necessarily, a single firm's profitability. This is a good opportunity to introduce the role of the strategist in outperforming industry norms.

Second is the idea that business is not always a zero-sum game—which is an assumption that is implicit in Porter's five-forces model. We discuss how companies can collaborate with suppliers for mutually beneficial outcomes.

The SUPPLEMENT below provides a rather counterintuitive perspective on rivalry in an industry. With examples from Yoplait and McDonald's, sometimes a firm can benefit from a rival's new product.

Extra Example: Firms Can Benefit from a Rival's New Product

Conventional wisdom that a rival's launch can hurt a firm's profits is often correct. But not always. Research has shown that companies sometimes see profits increase after a rival's rollout—even when they don't aggressively seek ways to undermine the new product's sales.

The underlying mechanism is rather straightforward: When a firm extends a product line, it often raises the prices of its existing products. These hikes may be designed to make the new product look cheaper and thus more attractive by comparison or to capture the value customers place on a broader line of offerings. As the company adjusts its pricing, its competitors can follow suit without risking customer defections over price.

For example, consider what happened with Yoplait became the first major producer to market low-fat yogurt in the United States. Although Dannon took a 5 percent hit in units sold during the new product's initial year, the vast majority of its customers did not defect to Yoplait. Instead, they preferred Dannon's style of yogurt. And, since Yoplait had raised prices across its product line, Dannon raised its prices as well, by more than 10 percent. Thus, despite the 5 percent decrease in volume, Dannon's revenue increased by 5 percent.

A similar dynamic plays out in fast food. My research shows that McDonald's franchisees who open additional outlets (a type of horizontal product extension) often price the menu items in all their locations higher than before. This allows competing Burger Kings to raise their prices as well. At independent Burger Kings in Silicon Valley, this has led to increase margins more than 10 percent of the time.

Source: Thomadsen, R. 2013. You can benefit from a rival's new product. *Harvard Business Review*. 91(4): 24.

The third issue we raise is that the five-forces analysis has often been criticized for being a static, rather than a dynamic, analysis. Brandenberger and Nalebuff introduced the concept of the value net, which we include in EXHIBIT 2.6.

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The concept of complementors is often considered to be the single most important contribution of value net analysis. Complements typically are products or services that have a potential impact on the value of the firms' own product and services. We provide the examples of complements (software and microprocessors) in the personal computer industry and the video game industry. (As we noted in an earlier supplement, Professor Michael Porter would not add complements to the "five forces" because they don't have a *direct linear relationship* to industry profitability. However, they clearly can have an impact on an industry's profitability.)

C. Strategic Groups within Industries

Most of your students are probably very interested in the automobile industry. EXHIBIT 2.7 provides a strategic grouping of the worldwide automobile industry. It is rather clear from the discussion in the text that the intensity of competition within strategic groups is much more intense than competition across groups.

Point out four benefits of strategic groups as an analytical tool:

1. Strategic groupings help a firm identify mobility barriers that protect a group from attacks by other groups.

2. It helps a firm to identify groups whose competitive position may be marginal or tenuous.

3. It helps chart the future directions of firms' strategies.

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4. It helps in thinking through the implications of each industry trend for the strategic group as a whole.

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It may be interesting to ask the students what dynamics they envision in the automobile industry, i.e., how membership in strategic groups may change and if new strategic groups may emerge.

Discussion Question 36: *What are some of the strategic groups in other industries with which you may be familiar? What are the implications? (e.g., retailing)*

We close with an example with an industry closely related to the one addressed in this section—motorcycles. The SUPPLEMENT below discusses the two major clusters in this industry and how the basis for competition is quite different.

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Extra Example: The Two Key Strategic Groups in the Motorcycle Industry

In most industries, firms cluster around a relatively small number of strategic positions and within each cluster hold similar ideas about how to compete. In the motorcycle industry, there are two major clusters of firms.

The Japanese producers—Honda, Yamaha, Suzuki, and Kawasaki—compete on technical innovation and lower costs. The Harley-Davidsons and Ducatis, in contrast, view their business through a very different lens—as entertainment. Here's how Federic Minoli, the CEO and chairman of Ducati from 1996 to 2007 described his decision to build a museum celebrating the firm before he repaired a damaged factory: "Ducati is not, or not only, a motorcycle company. We sell something more: a dream, passion, a piece of history."

Analyze most industries, and you will find a similar situation: two or three groups of firms jostling for position upon the same two or three competitive mountaintops. Now consider the major U.S. airlines. They all struggled for many years in cutthroat competition around the same position until Herb Kelleher of Southwest Airlines saw a different, low-cost way to compete.

Source: Gavetti, G. 2011. The new psychology of strategic leadership. *Harvard Business Review*. 89 (7/8): 118–125.

IV. Issue for Debate

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The topic should be of great interest because many students are familiar with drones (or perhaps own a drone or use drones for fun). What may be less well known is that drones are also extremely prevalent and effective in commercial applications such as building inspections. In effect, this is a good example of a new technology that has great potential for business (e.g., reducing costs) and workers (e.g., improving safety), but also faces challenges (e.g., privacy concerns). This tension between benefits and costs is certainly not unusual when new technologies get introduced into established markets. The instructor can point to other industries that have seen great efficiency benefits but also faced much opposition from various stakeholders (such as ridesharing).

Discussion Question 1: *If you were a local regulator, would you permit the use of drones?*

Response Guideline: The benefits of drones seem to outweigh potential costs. In 2016, the White House estimated that drones could lead to $82 billion in economic growth by 2025 and support up to 100,000 jobs. Less obvious benefits include increased safety in many professions such as building inspectors (less risk for slipping on roofs or ladders). Drones also have a lot of potential to assist first responders. This question can direct the discussion to the risk aversion of regulators. It also pushes students to think about how to balance the costs and benefits of new technologies that have the potential to revolutionize a range of commercial applications.

Discussion Question 2: *How should regulators respond to drone accidents?*

Response guideline: This would be a good application of stakeholder management and can be tied to the commercialization of other novel technologies. For instance, Elon Musk tweeted in 2013 following media coverage of a Tesla on fire: "Why does a Tesla fire [with] no

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injury get more media headlines than 100,000 gas car fires that kill [hundreds] of people per year?" A potential solution for regulators may be to allow commercial drone use (since the benefits are quite clear) and restrict private drone use (as the benefits are more experimental and uncertain).

> ***Discussion Question 3:*** *Do you think drone use could be successful in other commercial applications such as package delivery?*

Response guideline: Students should think about how the nature of the business may affect adaptation. Building inspections are generally seen as a public service whereas the "package delivery" sector is mostly privately organized (USPS being the exception of course). Private companies such as Amazon that want to break into the "drone delivery market" may engage in political strategies and sophisticated PR strategies (the following article illustrates nicely how Amazon tries to educate and lobby the public and politicians: https://goo.gl/1P5aUK).

V. Reflecting on Career Implications

PowerPoint Slide 34: Reflecting on Career Implications

Below, we provide some suggestions on how you can lead the discussion on the career implications for the material in Chapter 2.

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- **Creating the Environmentally Aware Organization:** Advancing your career requires constant scanning, monitoring, and intelligence gathering to find out not only about future job opportunities but also to understand how employers' expectations are changing. Consider using websites such as LinkedIn to find opportunities. Merely posting your resume on a site such as LinkedIn may not be enough. Instead, consider in what ways you can use such sites for scanning, monitoring, and intelligence gathering.

Students will likely be very interested in the topic of learning about new job opportunities and their associated skill requirements and compensation. Later in the course, there will be specific advice related to finding jobs through networking. Here, the point is to raise in students a general awareness of the types of career options available to them. On LinkedIn, job postings are grouped in various ways. Employers list desired skills and experience. Students should browse a number of these postings in order to identify trends concerning the types of skills that are currently in demand. To find compensation levels, students can join LinkedIn and ask experts. Compensation is a very tricky topic, though, because companies will tailor it to the specific skills of their chosen candidate. The point here is that students will gain from learning about the job market in their fields and how their specific skills and capabilities match up with what the market values. A related topic to consider is the value of experience. Ask students why employers value experience in addition to skills and training. The question does not have an obvious answer. Students should appreciate that as they progress through their careers, they will gain subtle and powerful capabilities related to, for example, leadership, handling complex situations, and stakeholder relations

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- **SWOT Analysis:** As an analytical method, SWOT analysis is applicable for individuals as it is for firms. It is important for you to periodically evaluate your strengths and weaknesses as well as potential opportunities and threats to your career. Such analysis should be followed by efforts to address your weaknesses by improving your skills and capabilities.

The SWOT analysis directly pertains to individuals, and students will usually grasp how it applies to them personally. A useful exercise is to have students complete a SWOT analysis on themselves and then pair with another and share reviews. As a check, ask student volunteers to share an element from each part to ensure that students are correctly classifying the elements. The next step is to ask students to make a plan to address their weaknesses. Plans may be of two types. One is to develop weak skills to the point they are not weaknesses. Two is to make a plan to avoid the weakness. For example, if a student were weak at quantitative analysis, then he or she could pursue a career, such as copywriting, that does not rely on that skill so much. The point here is that students should be aware of their SWOT profile and plan their careers accordingly.

- **General Environment:** The general environment consists of several segments, such as the demographic, sociocultural, political/legal, technological, economic, and global environments. It would be useful to evaluate how each of these segments can affect your career opportunities. Identify two or three specific trends (e.g., rapid technological change, aging of the population, increase in minimum wages) and their impact on your choice of careers. These also provide possibilities for you to add value to your organization.

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When students choose a segment, they should identify a trend within that segment. Then they should be able to identify an industry that would benefit from that trend. This industry is therefore likely to be a growth industry that may provide good career opportunities. It also may be useful to identify some weaknesses in this logic, such as reversal of a trend, or having an industry become a magnet for workers, such as computer programming, where the labor supply may exceed demand. Within industries, there may be specific functions that will offer growth in areas that firms can exploit. An example may be e-business, where firms in many industries are revolutionizing their distribution channels in response to the increasing acceptance by consumers of e-tailing.

- **Five-Forces Analysis:** Before you go for a job interview, consider the five forces affecting the industry within which the firm competes. This will help you to appear knowledgeable about the industry and increase your odds of landing the job. It also can help you to decide if you want to work for that organization. If the "forces" are unfavorable, the long-term profit potential of the industry may be unattractive, leading to fewer resources available and—all other things being equal— fewer career opportunities.

It is good advice to do due diligence of a firm and its industry prior to a job interview. It helps job candidates to appear knowledgeable about their prospective employers, which may be a differentiator. In class discussions, it is probably less important to make a general conclusion of "favorableness" vs. "unfavorableness." Better is to identify the specific forces that are the strongest threats to the industry. Then develop an argument as to how students, the candidates,

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can help firms to address these threats. Later, provided that students have offers from firms in multiple industries, students may use the assessment of industry overall attractiveness in their decision as to which offer to accept. In discussions of this issue, it may be useful to remind students that firm characteristics are a stronger explanation of firm success than industry environment. It may be better to work for a strong firm in an unattractive industry than for a weak firm in an attractive industry.

VI. Summary

Managers must analyze the external environment to minimize or eliminate threats and exploit opportunities. This involves a continuous process of environmental scanning and monitoring, as well as obtaining competitive intelligence on present and potential rivals. These activities provide valuable inputs for developing forecasts. In addition, many firms use scenario planning to anticipate and respond to volatile and disruptive environmental changes.

We identified two types of environment: the general environment and the competitive environment. The six segments of the general environment are demographic, sociocultural, political/legal, technological, economic, and global. Trends and events occurring in these segments, such as the aging of the population, higher percentages of women in the workplace, governmental legislation, and increasing (or decreasing) interest rates, can have a dramatic effect on your firm. A given trend may have a positive impact on some industries and a negative or neutral impact, or none at all on others.

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The competitive environment consists of industry-related factors and has a more direct impact than the general environment. Porter's five-forces model of industry analysis includes the threat of new entrants, buyer power, supplier power, threat of substitutes, and rivalry among competitors. The intensity of these factors determines, in large part, the average expected level of profitability in an industry. A sound awareness of such factors, both individually and in combination, is beneficial not only for deciding what industries to enter but also for assessing how a firm can improve its competitive position. We also addressed some of the limitations of Porter's five-forces model, including its zero-sum perspective and its omission of the key role of complements. Although we discussed the general environment and competitive environment in separate sections, they are quite interdependent. A given environmental trend or event, such as changes in the ethnic composition of a population or a technological innovation, typically has a much greater impact on some industries than on others.

The concept of strategic groups is also very important to the external environment of a firm. No two organizations are completely different nor are they exactly the same. The question is how to group firms in an industry on the basis of similarities in their resources and strategies. The strategic groups concept is valuable for determining mobility barriers across groups, identifying groups with marginal competitive positions, charting the future directions of firm strategies, and assessing the implications of industry trends for the strategic group as a whole.

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Chapter 2: Analyzing the External Environment of the Firm

Explain the profitability of an industry (of your choice) by applying the tools that you learned in this chapter (five-forces analysis). How can the five-forces zero-sum perspective be a disadvantage?

Teaching Suggestions:

You can organize the discussion on this topic around the following sub-questions:

★ What are the five forces that drive the profitability in an industry?

The five forces are:
1. The threat of new entrants
2. The bargaining power of suppliers
3. The bargaining power of buyers
4. The threat of substitute products and services
5. The intensity of rivalry among competitors in an industry

★ What are the barriers to entry into a particular industry? Are they high or low? What are the implications?

Six major sources of entry barriers as outlined in the text are:
1. Economies of scale
2. Product differentiation
3. Capital requirements
4. Switching costs (one-time costs that the buyer faces when switching from one supplier's product or service to another)
5. Access to distribution channels
6. Cost disadvantages independent of scale (These derive from: proprietary product, favorable access to raw materials, government subsidies and, favorable government policies)

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★ Who are the buyers in this industry? Are they powerful? What makes the buyers powerful (not powerful)? Are the buyers likely to engage in backward integration?

★ What are the implications of buyers bargaining power?

★ Who are the suppliers to your industry? Do you think the suppliers are powerful? What makes the suppliers powerful (not powerful) in your industry? Are there any 'switching costs?' What are the implications of high bargaining power of the suppliers in the industry?

★ If you are a firm in this industry, how would you define competition? Would you consider all firms operating in the industry as your competitors? Why/why not?

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★ What are "strategic groups?" How would you know the "strategic groups" in your industry? What kind of dimensions should you choose when mapping the "strategic groups"? Why is it important to understand "strategic groups"? *(We provide the example of the worldwide automobile industry.)*

The concept of 'strategic groups' is important because competition would be more intense among firms within the same strategic group as compared to competition with other firms in the industry. Some dimensions that can be used for mapping strategic groups are: breadth of product and geographic scope, price/quality, degree of vertical integration etc.

You should emphasize that for strategic group mapping to serve any meaningful purpose, the dimensions should be chosen in a manner that they reflect the variety of strategic combinations in the industry. For example, in an industry where there is severe price-base competition, price may not be the right dimension to choose. Similarly, if all firms have the same level of product differentiation, then choosing product differentiation as a dimension would not serve the purpose.

★ What are the substitutes to your products or services? How do substitutes impact the profitability of your industry?

You might want to make a point here that identifying substitutes can be quite a difficult task sometimes. Firms in seemingly unrelated industries may be providing products or services that act as substitutes to each other. The example given in the text on the substitution between airline industry and teleconferencing would help highlight this point.

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Some more interesting questions to ask would be the following:

★ If two industries have the same profitability levels, can you employ a common strategy in both the industries?

Even though two industries might have the same profitability levels, the underlying industry structures can be entirely different. For example, in both the automobile industry and in the Internet-based businesses, profit margins are quite low. However, while the entry barriers into the automobile industry are very high, the barriers are very low into the Internet-based businesses. Competition is intense in both the industries, whereas supplier and buyer bargaining powers are quite low. On the other hand, threat from substitutes such as the 'brick-and-mortar' stores, is very high in the Internet-based businesses, whereas the threat from substitutes is low in the automobile industry. (Some students might argue that the airline industry is a strong substitute and you would have to deal with that objection.) Thus, even if a firm operates in both these industries, it needs to formulate quite different strategies to suit the particular industry situation.

★ Why is the five-force analysis important?

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It is important to understand these five forces because they affect a firm's ability to compete in a given market. This analysis helps in deciding whether or not to remain in a particular industry and also in choosing industries to enter. A sound understanding of the forces operating in an industry helps in assessing how to improve the firm's competitive position with regard to each of the five forces. You can ask students to give their own ideas on what strategies they would employ in the particular industries they have chosen for analysis.

★ Is the five-force analysis "zero sum" in perspective? Is that a disadvantage?

It would often be the case that students, in the position of a company, think about counteracting the effects of each force and blunting it. This is the essence of the zero-sum perspective. You can explain the importance of thinking "win-win" and establishing collaborative partnerships with suppliers and customers. For example, establishing long-term mutually beneficial relationships with suppliers improves a firm's ability to implement just-in-time (JIT) inventory systems, which let it manage inventories better and respond quickly to the market demands.

★ Do the competitive forces remain the same over a period of time? What impact will it have on profitability?

The key point is that in the five-force analysis, we are essentially taking a point in time and trying to understand the industry situation at that point in time. This is a static approach to understanding the competitive environment. However, these external forces and the strategies of the firms within industries change over time and thus change the structure of the industry itself. In order to understand how the profitability changes over time, game theoretic approaches are being used.

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★ What is "Value Net?" Who are on the vertical and horizontal dimensions? How are those on the vertical dimension different from those on the horizontal dimension? Who are complementors?" How are complements different from substitutes? *(We provide the example of the video game industry.)*

The value net represents all players in the game and analyzes how their interactions affect a firm's ability to generate and appropriate value.

Suppliers and customers form the vertical dimension of the value net and the firm engages in transactions with them.

Substitutes and complements are on the horizontal dimension of the value net. These are the players with who the firm interacts but does not necessarily transact.

Substitute products or services serve the same purpose that the products and services from a chosen industry serve. Substitutes accentuate competition.

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Complements are typically products or services that have a potential impact on the value of a firm's own products or services. The firms that produce complements are referred to as "complementors." For example, very sophisticated cameras may be useless if we do not have high-quality film to produce quality pictures. Powerful hardware might prove useless without software to make it work and highly sophisticated software may be useless if there is no hardware to support its working. Thus, complements in essence help to increase the performance and efficiency of products or services of a particular industry and thus improve their competitive situation vis-à-vis other products and substitutes.

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End-of-Chapter Teaching Notes

Chapter 2: Analyzing the External Environment of the Firm

Summary Review Questions

1. Why must managers be aware of a firm's external environment? (in the text, Enhancing Awareness of the External Environment, LO 2-1)

Response:

Being responsive to the external environment enables firms to avoid strategic mistakes. It is possible for firms to become internally focused, efficient producers of obsolete goods and services (e.g. buggy whips, carbon paper). Rather, managers need to respond to opportunities and threats from the external environment in order to develop the most successful products and services.

2. What is gathering and analyzing competitive intelligence and why is it important for firms to engage in it? (in the text, Enhancing Awareness of the External Environment, LO 2-2)

Response:

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Competitive intelligence is a firm's activities of collecting and interpreting data on competitors, defining and understanding the industry, and identifying competitors' strengths and weaknesses. It is not spying, fortune-telling, simple data collection, or an isolated activity within a firm. The purpose of competitive intelligence is to increase management's awareness of developments in the external environment, thereby increasing the quality of strategic decisions.

3. Discuss and describe the six elements of the external environment. (in the text, The General Environment, LO 2-4)

Response:

The six elements of the general environment are the demographic segment, the sociocultural segment, the political/ legal segment, the technological segment, the economic segment, and the global segment. The demographic segment refers to the statistics of a population, such as age, income characteristics, ethnic groups, and geographic distribution. The sociocultural segment refers to the values, beliefs, and lifestyles of a country. The political/legal segment refers to the creation and use of power within a country, including the effect of various regulations, including the areas of environmental protection, employment discrimination protection, and taxes.

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The technological segment refers to new products and services derived from advances in engineering, applied science, and/or pure science. These new products and services can change manufacturing processes, create new industries, and alter the boundaries between industries. The economic segment refers to the level and change in monetary and macroeconomic factors such as unemployment, inflation, interest rates, and economic growth. The global segment refers to effects on a country's business environment from abroad, and include factors such as foreign competition, foreign market opportunities, foreign supply opportunities, legal changes due to international treaties, and regional economic integration.

4. Select one of these elements and describe some changes relating to it in an industry that interests you. (in text, The Competitive Environment, LO 2-5)

Response:

The answer will vary according to segment and industry chosen. Exhibit 2.5 may summarize some of the possible findings. The purpose of this question is to get students to classify various environmental changes into the segments and articulate why a change belongs in a particular segment.

5. Describe how the five forces can be used to determine the average expected profitability in an industry. (in text, The Competitive Environment, LO 2-5)

Response:

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The five-forces model consists of the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, the threat of substitute products and services, and the intensity of rivalry among competitors in an industry. Each force can be looked at as a way that the industry environment limits a firm's ability to earn profits through either raising prices or lowering costs.

The threat of new entrants limits a firm's ability to raise prices because then a new entrant may decide to enter the industry and offer a lower price. The bargaining power of buyers directly limits a firm's ability to raise prices. The bargaining power of suppliers directly limits a firm's ability to lower costs. The threat of substitute products and services limits a firm's ability to raise prices because customers would then buy the substitutes. The intensity of rivalry among competitors in an industry limits a firm's ability to raise prices because then customers would buy from a competitor.

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6. What are some of the limitations (or caveats) in using five-forces analysis? (in text, The Competitive Environment, LO 2-5)

Response:

Three limitations of the five-forces analysis are 1) the implication that low-profitability industries should be avoided may not be optimal. Low-profitability industries may be profitable opportunities for firms with innovative business models that change the competitive landscape. 2) The five-forces model assumes a zero-sum game, with a firm's loss of profitability associated with another firm's gain. However, through strategic alliances or other forms of collaboration with suppliers, buyers, or other industry players, firms can gain both profitability and competitiveness. 3) The five-forces model is static and does not account for constant changes in competitive position that characterize many industries. Included in the dynamic analyses is the effect of complements, or other products and services that affect the value of a firm's own products and services. For example, software is a complement to hardware. Dynamic interactions between firms and complements can affect the profitability prospects for a firm outside of the five-forces model.

7. Explain how the general environment and industry environment are highly related. How can such interrelationships affect the profitability of a firm or industry? (in text, The General Environment and The Competitive Environment, LO 2-4 and LO 2-5)

Response:

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The general environment can affect all of the five forces in various ways. A growing economy can reduce the intensity of rivalry within the industry because firms will be scrambling to meet growing demand. There is a detailed explanation of how the Internet, a development in the technological segment, affects each of the five forces.

8. Explain the concept of strategic groups. What are the performance implications? (in text, The Competitive Environment, LO 2-7)

Response:

Strategic groups are groups of firms, usually within an industry, that share similar strategies. The performance implications are that firms can group themselves with close competitors and 1) identify barriers between groups, 2) identify positions within the industry that are marginal or tenuous, and 3) chart directions for future strategic development. Strategic group analysis is a more fine-grained way to conduct competitor analysis, as the competitive environment of an industry may differ from the competitive environment of the strategic group.

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Experiential Exercises and Application Questions

1. Strategy Spotlight 2.1 discusses the growing importance of environmental concerns and illustrates how companies in different industries deal with plastic waste issues. Many other environmental problems such as greenhouse gas emissions and the resulting climate change issues are major concerns for today's businesses and governments. Pick an industry with high greenhouse gas emissions such as electric utilities, air transportation, or livestock agriculture and identify the threats and opportunities facing the industries. Do you think companies with substantial greenhouse gas emissions should proactively address their environmental impact?

Response:

This question should result in a lively discussion. Many students will agree that companies should address environmental concerns related to climate change. What may be more controversial is how companies should be compelled to become more environmentally sustainable.

Some students may favor a regulatory approach. The instructor can point out that this may be an effective way to compel industries to become greener since this may overcome collective action problems and free rider issues in an industry. The strategic drawback of this approach is that it will be very difficult for any company to differentiate its business if regulatory action triggers resource commitments to green technologies for all companies in an industry.

Other students may favor a more proactive approach by individual companies. In other words, companies proactively and voluntarily search for ways to reduce greenhouse emissions. The instructor may point to the strategic benefit of this approach: Given that environmental concerns regarding climate change are here to stay, companies that proactively invest in green technology may establish a first-mover advantage and differentiate their image and brand from the competition. The instructor may offer some examples of companies that have taken a proactive approach. Good examples can be found in the book "Green to Gold" by Daniel Esty and Andrew Winston.

2. Select one of the following industries: personal computers, airlines, or automobiles. For this industry, evaluate the strength of each of Porter's five forces as well as complementors.

Response:

This exercise is very useful for helping students understand the value of the five-forces model. For undergraduate and even graduate classes, it might be useful to work with only one force at a time. In general, students may identify a number of firms and organizations for each of the five forces. To evaluate the strength of each force, it is important to refer to relevant characteristics. The list below shows these:

- Threat of new entrants—you can look at the barriers to entry for the industry, as indicated by economies of scale, product differentiation, capital requirements, and switching costs,

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as well as other types of cost disadvantages to new entrants, such as proprietary products, favorable access to raw materials, government subsidies, and favorable government policies.

- Bargaining power of buyers—identify buyers who are large or in concentrated buyer industries, standard or undifferentiated products, few buyer switching costs, buyer with low profits, buyer has a credible threat of backwards integration, or the buyer views the firm's products or services as undifferentiated.
- Bargaining power of suppliers—it is often a challenge to find suppliers, but to the extent you can, look for suppliers that are large and concentrated (few in number), suppliers with few substitutes, suppliers that view the firm's industry as a minor proportion of its sales, suppliers that provide an important input, suppliers with differentiated products, and suppliers that pose a credible threat of forward integration.
- Threat of substitute products and services—identify substitutes that are a) outside the industry, and b) that are an economical and feasible alternative for buyers.
- Intensity of rivalry—identify rivals within the industry and evaluate each rival's product offerings for being lower priced or of higher quality than the firm's offerings.

Then have students put them all together and provide a summary evaluation of the overall ability of the firm to set prices and control costs.

3. Imagine yourself as the CEO of a large firm in an industry in which you are interested. Please (1) identify major trends in the general environment, (2) analyze their impact on the firm, and (3) identify major sources of information to monitor these trends. (Use Internet and library resources.)

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Response:

Students should respond with a variety of industries and approaches. It may be useful to have students justify their classification of trends into segments of the general environment. It may also be useful to have students justify why the trends they have identified are major trends and not minor trends. And you can ask students to classify their chosen trends as threats or opportunities. If students have focused on one, say, opportunity, then ask them to consider threats.

As for sources of information, there are many good sources from the government. Try the census department, the Bureau of Economic Analysis, Department of Commerce, Department of Labor, and the Central Intelligence Agency. Many of these sources are freely available directly from the government or through libraries. Some libraries of institutions of higher education subscribe to industry analysts reports, which often include analyses of the business environment. In addition, company websites often include information about potential market size and trends, although note that company websites are inherently a biased source of information.

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4. Analyze movements across the strategic groups in the U.S. retail industry. How do these movements within this industry change the nature of competition?

Response:

We suggest following these five steps. First, develop a list of retailers. The list may include only local retailers that the students are familiar with, or the stores within a local mall or shopping area, or even a comprehensive list of all retailers in the region.

Second, choose two dimensions for mapping the firms. Depending on the type of stores chosen, we suggest breadth of product line, degree of vertical integration, average store size, pricing strategy, or target market (broad versus niche).

Third, for each store assign a value for each dimension and plot it on the strategic group space. For example, Wal-Mart would have a broad product line, high vertical integration (it often buys directly from suppliers, not wholesalers), large size, low pricing, and broad target market. These assessments will determine its location on the two chosen dimensions. In addition, for at least one firm get a sense of how it has changed in the past year or so.

Fourth, after putting your firms on the strategic group space, look for clusters and spaces between clusters. Evaluate each cluster. Ask students which clusters would be more profitable and which less so. And most important, ask why. Students should be able to articulate the desirability of each cluster, and link their reasoning to the dimensions used for mapping the firms. For the spaces, ask students if any of the spaces would be desirable places. Often, the groupings do not make sense. If that were the case, then challenge students to come up with dimensions that do make sense. You should help students to understand that they have control over how the strategic space is defined.

Fifth, for the firm that has changed in the past year, chart that movement on the strategic group space. No matter what dimensions you use, this firm will be moving away from some competitors and toward others. Ask students how this movement affects the competition between this firm and others. The purpose of the discussion is to get students to appreciate that increasing distance associates with less competition and decreasing distance between firms represents a threat.

5. What are the major trends in the general environment that have impacted the U.S. pharmaceutical industry?

Response:

The U.S. pharmaceutical industry consists of firms that manufacture and market medicines for people. All segments impact this industry. The demographic segment affects demand, as the aging baby-boomers require age-specific medicines and marketing approaches. Also, older people tend to require more medicines than younger people, so market demand in the U.S. is growing. The sociocultural segment affects medicinal preferences. People value their health and trust their doctors rather than use traditional medicines.

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The political/legal segment is extremely important due to the regulatory approval process for new medicines, intellectual property right protection, government insurance programs, and price controls. Regulatory approval of new medicines is extremely rigorous and costly. To recoup the costs of obtaining approval, pharmaceutical firms exploit their monopoly power that stems from the patents and trademarks on the medicines. And this monopoly power enables pharmaceutical companies to charge high prices. The recent trend in government support for prescription drugs through Medicare, and the recent and ongoing implementation of near-universal health care and prescription programs has two impacts: 1) more patients will be getting prescriptions, which increases revenues, and 2) more patients will be covered by insurance, which will increase buyer power and decrease revenue to pharmaceutical companies.

The technological segment affects the new product development process. Biotechnology involves the use of living organisms to develop new drugs and has created an explosion in potential new medicines. Other technologies developed by these companies are the ability to test thousands of substances at a time and to map the human genome, which helps us to understand the causes and potential cures of many ailments.

The economic segment affects the industry, as general economic growth affects market potential. The recent recession has therefore hurt the industry. In addition, expected interest rates affect the financial prospects of many biotech firms. These firms often take decades to develop new drugs and bring them to the market. Lower interest rates enable them to make their investors' capital last longer. The global segment affects the industry in a number of ways. Foreign markets offer sales opportunities. Foreign labs are effective partners for collaboration. However, foreign countries often put price controls on medicines, which limit profit potential from foreign sales. And foreign competitors often do not respect the intellectual property of U.S. firms, giving rise to loss through piracy.

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6. Go to the Internet and look up www.kroger.com. What are some of the five forces driving industry competition that are affecting the profitability of this firm?

Response:

A couple of clicks first to the "about the Kroger company" at the bottom of the home page, then to the Kroger Fact Books on the right side of the page will get you to the fact books. These include information on the following topics.

The first step is to define Kroger's industry. While Kroger does have jewelry stores and houseware stores, its primary activity is in supermarkets. We will focus on supermarkets.

For the threat of new entrants, this force is weak. Kroger notes that the industry is consolidating. There are very large barriers to entry due to capital requirements and economies of scale. The bargaining power of buyers is weak. The buyers are the general public, which is an aggregation of very small customers. No customer is a very large part of the market, and customers will not have an information advantage over Kroger. The primary source of buyer power is the ability of customers to shop at the competition. The bargaining power of suppliers is moderate. Some of

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Kroger's stated competitive advantages stem from the brand equity of suppliers' products, such as Kitchen Aid, Levis, Dockers, and Nikon. However, Kroger counters supplier power by developing a series of corporate brands, and by backwards integrating into the suppliers' industries. The threat of substitute products and services is limited, as customers have developed a habit of doing most of their food shopping at supermarkets as opposed to farmers' markets, convenience stores, or general stores (although students may note the growing food offerings at retailers such as Wal-Mart or Target). And note that Kroger includes a number of other types of store formats, like marketplace stores and convenience stores, to compete in substitute industries. Alternatives do not have a very high market share. The intensity of rivalry among competitors in the industry is very strong. Kroger competes with Walmart, Meijer, and other chains of supermarkets in every part of the country. These competitors are large, successful, and aggressive. Kroger limits rivalry by acquiring smaller stores and chains where possible. One of Kroger's strategies for dealing with rivalry is to encourage customer loyalty through various programs such as shopper cards and a customer relations management system in conjunction with London-based dunnhumby.

Ethics Questions

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1. What are some of the legal and ethical issues involved in collecting competitor intelligence in the following situations?

a. Hotel A sends an employee posing as a potential client to Hotel B to find out who Hotel B's major corporate customers are.

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Response:

The scheme risks exposure. Hotel B might find out who the employee is and find out that he or she represents Hotel A. Hotel B's list of major corporate customers is likely to be a trade secret, and Hotel A's use of fraud to gain the trade secret is, depending on state law and the specific circumstances, likely to be a crime.

It is likely that Hotel B will share this information with the press, trade publications, or other media. It is also possible that Hotel B will use this information to tarnish Hotel A's reputation. Hotel A's business could be affected and shareholders embarrassed. The cost to Hotel A of overcoming these shortcomings is likely to exceed whatever gain was possible.

b. A firm hires an MBA student to collect information directly from a competitor while claiming the information is for a course project.

Response:

It is possible that this action would be a crime, although doubtful. The competitor is not likely to share trade secrets, because the course project is not likely to be kept confidential, but that depends on the circumstances.

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However, the scheme is certainly fraudulent and therefore unethical. The firm is using the MBA student as a spy, which is abusive to the MBA student. The student's college or university, though perhaps not directly involved, will have its name associated with the scheme.

In addition, the competitor can use the scheme to discredit the firm and embarrass its shareholders.

c. A firm advertises a nonexistent position and interviews a rival's employees with the intention of obtaining competitor information.

Response:

The scheme is fraudulent. Advertising a position without an intention of hiring is unethical. If the scheme succeeds in obtaining trade secrets, then it is probably a violation of law. And the coercive treatment of the rival's employees is a problem.

The possibility of criminal violations occurs within the purview of many states' trade secret laws. If any individual suffers any harm, then civil damages are possible.

But the unethical nature of this scheme is likely to be the largest problem. The rival can use the firm's actions to discredit the firm and embarrass its shareholders.

2. What are some of the ethical implications that arise when a firm tries to exploit its power over a supplier?

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Response:

A monopsonist, or a firm that is the only buyer in a market, has great power over suppliers. It might try to exploit this power by forcing the supplier to reduce prices or provide extra services. In the extreme, suppliers will be forced to cut costs, lay off employees, cut salaries, and forego investments in new technologies or capabilities. The downside of these actions is that the supplier is less capable of contributing to industry development by infusing it with innovations.

CONNECT RESOURCES

Comprehension Case
- Mayo Clinic's Transformation and Adaptation

Case Analysis
- Mayo Clinic's Pursuit of a Health Care-Centric Platform
- Gas versus Hybrids versus Electric: A Battle of Substitutes

Video Case
- Analyzing Industry Forces
- Analyzing the Macro-Environment
- SWOT Analysis

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