1.3.1 Strategic and Economic Analysis of Businesses[1]

Unit: Unit 1 – Treasury Strategy

Module: Module 1 – Corporate strategy

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Summary: A look at some of the several tools available to make a strategic, rather than a financial, analysis of a business. The reading looks at which are more suitable in some cases than others.

Keywords: financial analysis, strategic analysis, market, competition, critical success factors, differentiation, strategic business unit

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[1] Included in this reading is an activity requiring you to post in the online forum. This activity is indicated by the icon. You are expected to post forum activities to the appropriate forum within the two-week timeframe of the module. Please see the study timetable for reference.

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Learning outcomes:

1. To understand the difference between a financial analysis and strategic analysis.
2. To understand the possible sources of industry analysis.
3. To understand the four dimensions of strategic analysis:
   a) wider economic environment
   b) industry market
   c) nature of competition
   d) the firm and its management
4. To understand the standard analysis tools and when they might each be appropriate.
   a) PEST analysis
   b) market life cycle
   c) market environmental matrix
   d) Porter's five forces
   e) Value Chain analysis
   f) BCG production-portfolio matrix
   g) Ansoff product-market matrix
   h) SWOT analysis
5. To understand the concept of a strategic business unit (SBU)

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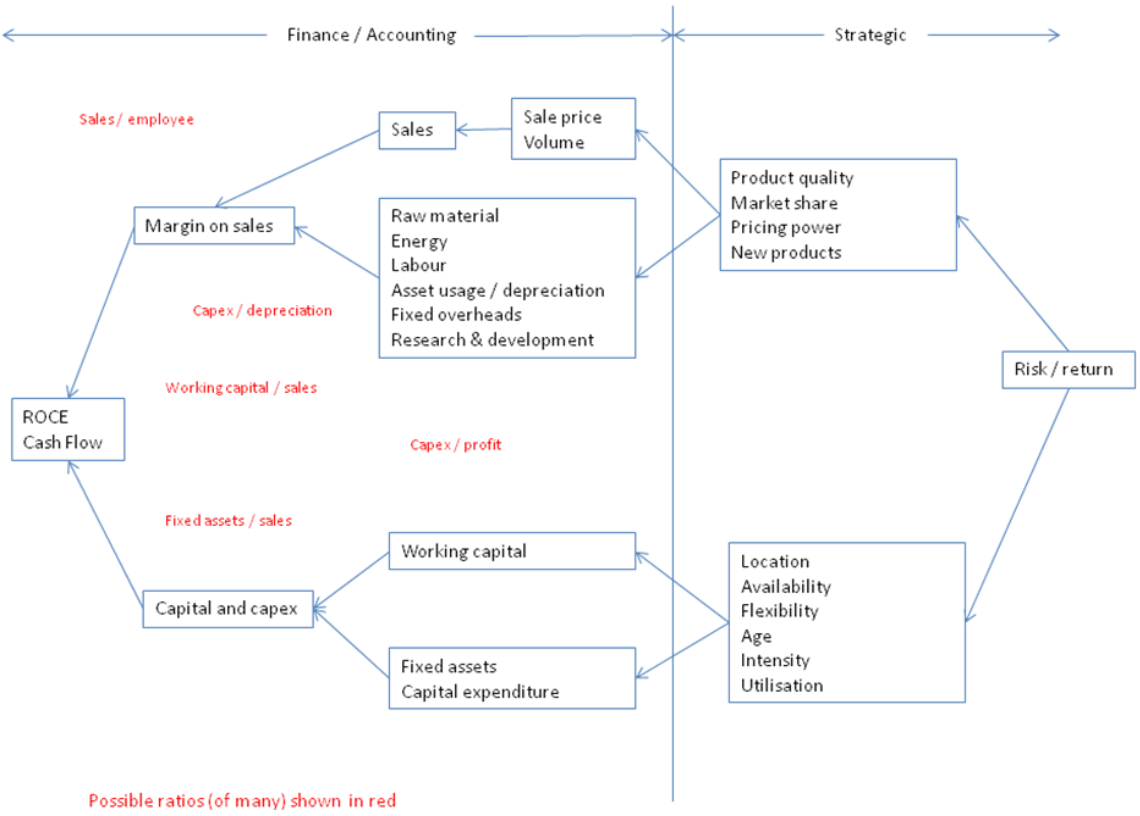
1 Introduction

The language of finance is consistent (unlike disparate businesses) which enables the financial community to apply a powerful array of tools to discuss, manage or solve problems from disparate situations. Financial analysis tools can be applied to any business, but without an understanding of the underlying businesses we are in danger of making a wrong diagnosis or a wrong prognosis.

As we get into the detail of financial problems such as financial analysis and control, project evaluation and business valuation it is easy to see the need for understanding the factors which influence sales growth rates, profit margins, growth of overheads, the need for marketing and R&D expenditures etc. In managing capital structure, funding and liquidity, the crucial considerations are the level and nature of business risks, and their impact on cash flows.

In the diagram below, we link back from the finance/accounting performance, e.g. ROCE, to strategic/business performance parameters such as price, market share and capacity utilisation. This is crucial to properly understanding financial performance.

Exhibit 1: Relationships between financial and strategic analysis



So, although financial ratio analysis is a great place to start – and we will look at this elsewhere in the course, especially with regard to financial profiling and credit risk - it is only part of the story.

Economic and strategic analysis or "non-financial analysis" is different from financial analysis. Financial analysis is about applying some fairly tight, well-agreed logic to a finite set of readily-available data, and the outcomes are usually straightforward to interpret. Economic and strategic analysis involves, first finding the relevant data, recognising it when you see it, then trying out various analytical approaches and using judgement to identify what are the most important factors in the situation. Economic and strategic analysis is comparatively judgemental.

This reading examines some ways in which various industries or markets can be assessed in terms of their economic attractiveness, future potential and risk profiles, using a number of popular analytical models. This adds up to a kind of strategic risk-return mapping. It is a pre-requisite for understanding the business for a host of applications, from generating business strategy through to managing value creation and managing financial / treasury risk.

As you will see, it can be difficult to undertake these analyses without a detailed knowledge of the firm, the industry and its competitors. The financial information a company is required to produce is insufficient for these purposes. It is also unlikely that sufficient industry and competitor information will be available on the company's website. That said, it can be helpful if a firm has produced a prospectus for an equity or debt issue, although these are often not available from company websites. Broker's reports can be very useful as they often contain competitor and industry data. Some investment banks may also publish industry reports, comprehensive documents published periodically on particular sectors. Trade bodies can also be useful sources for industry statistics.

2 Models and concepts for analysis

Analysis of the non-financials can be structured by arranging questions and findings under the following four headings, while noting that the second and third of these are closely linked;

- the wider economic and regulatory environment of business
- industry-market characteristics
- the nature of competition
- the firm and its management

The key features identified by analysis of a particular industry will have widespread implications for the company's strategic and operational priorities.

Generally, firms can choose which markets they would like to operate within and which they would not. However, such decisions are not easily made and even less easily implemented. Entry to or exit from particular markets or industries can take many years to achieve and is fraught with problems and risks as well as filled with potential. As a consequence, a great deal of analysis is often called for and it is in this area that strategic planners spend most of their time.

In this section we shall be describing models which can be related to the four levels indicated above plus an overall/summary approach (SWOT):

Level	Objective	Model
Economy	Identify wider environmental issues	Environmental Impact Matrix, often referred to as PEST Analysis **(1)**
Industry	Assess industry characteristics	Market Life Cycle **(2)** Market Environmental Matrix **(3)**
Competition	Evaluate competition position	Porter's Five Forces **(4)** Value Chain Analysis **(5)**
Company	Make strategic choices	BCG Production-portfolio Matrix **(6)** Ansoff Product-Market Matrix **(7)**
General		SWOT Analysis **(8)**

But first, we need to describe three generally applicable and relevant concepts: Competitive Variables, Competitive Advantage and Strategic Business Units. As with the models themselves we will be introducing some strategic management jargon, but you will hear it used, so you need to be familiar with it.

2.1 Competitive variables

Identifying the competitive variables which are most highly valued by customers is fundamental to understanding the attractiveness of any particular industry or market. These variables establish the basis of competition in a particular market. By focusing on these key competitive variables, an organisation should be able to build and maintain a profitable position in an industry. These are often referred to as "critical success factors".

There are two main competitive variables:

- *Price*. Firms seek to compete on the basis of lower cost while maintaining a market-led price, or to cut prices in a bid to gain market share.
- *Differentiation* – which in turn can be split in two:
    - *Features differentiation*. Firms seek to differentiate a product offering by providing improved quality or performance over competing products. These features can be either tangible (easily perceived) or intangible (relating to image or reputation), but the differentiation has to be perceived by the customer.
    - *Execution differentiation*. By better performance in sales and after-sales service, a firm can differentiate itself from other competitors. This can include: product availability, reliability and selling intensity.

Every industry or market will have a set of key competitive variables which revolve around price or differentiation and, although they may vary over time, firms in the industry have to plan their strategic and operating strategies in response to them. The implications of operating in a price / low-cost versus a differentiation environment are huge. If customers buy purely on price (a so-called 'commodity market'), competition must be on the basis of lowest-cost production to meet the market's quality standard. Examples include petrol retailing, warehouse space and outright foreign exchange. If customers buy on features or service, competing successfully will require investment in R&D, marketing, training etc – examples include consultancy services, outsourcing suppliers and patented pharmaceuticals. The challenge for most sectors and businesses is to avoid commoditisation, for instance the loss or expiry of a patent so the drug becomes 'generic'.

Many commodity industries go to great lengths to become differentiated – examples are the high-end automotive industry, and the success of Apple Computers in the early 21st century.

2.2 Competitive advantage

By identifying the variables and directing the organisation's resources towards them, a firm can create a competitive advantage, which may or may not be a "sustainable competitive advantage". Competitive advantage means better margins, superior return on capital and shareholder value creation, via new projects or the ongoing business. Sustainable advantage could stem from a superior R&D function, patents, location, dominant market share, reputation for excellence, low-cost feed-stocks etc. Such situations may be self-perpetuating ("virtuous circles"). In theory, all firms try to maximise their competitive advantage – subject to the resources required. In practice, there are many trade-offs involved, which are related to the conflicting goals which organisations have. It is not too difficult to achieve a temporary competitive advantage in an industry if the organisation is prepared (or able) to lower its prices or invest to differentiate itself. The trick is to sustain this advantage over time.

2.3 Strategic business units (SBUs)

To facilitate strategic planning, many companies divide their operations into Strategic Business Units to assess their positions in markets. The term and idea possibly originate with General Electric's business in the Sixties.

Companies may assess their business in different ways, for example by division or profit centre. The following analysis still holds. For simplicity, we refer to SBUs in this reading.

An SBU is a unit focused upon achieving the organisation's strategy in a defined market. Although SBUs are commonly defined by their markets, an SBU may consist of a particular product line or plant or manager or geographical region and, in some organisations, intermediate SBUs are formed by grouping several smaller SBUs. Small companies may have only one SBU. Large, diversified firms may have tens and possibly hundreds of SBUs. In such a situation, the overall corporate strategy is seen as an 'umbrella' under which each SBU has to create and implement its own strategy.

One advantage of the SBU approach is that senior management can manage the organisation in a more 'hands-off' manner. In the same way that an individual would manage a portfolio of equity shares by increasing or reducing their shareholding through additional investment or divestment, management would decide which SBUs deserve greater resources and which deserve less. This concept of portfolio management will be returned to later in this reading when we consider strategic choices.

Many large firms favour a SBU structure because each SBU is motivated to achieve its own profit targets, set out in a budget and usually including other measures for success, such as cash flow, working capital, capex targets etc. In the absence of compulsion, such measures encourage an SBU to use the services and products of other SBUs in the same organisation only if they are more attractively priced or differentiated compared to similar resources from outside the organisation. Due to this high degree of separation, if and when it comes time to sell or close down a SBU, the impact on other parts of the total organisation should be lower.

The SBU structure can also create difficulties for organisations. First, a lack of internal co-operation can emerge since the management of each SBU is likely to look out for its own interests rather than those of the group. Sometimes SBUs will find themselves competing against each other, even SBUs in the same division. For example, multinationals might find that sales units in two countries chase one sale, thus driving up one SBUs result at the expense of the group. Second, there may be a reluctance to accept innovations or policies which have been developed elsewhere in the Group. SBU managements often cherish their independence and therefore may seek to differentiate themselves rather than seek ways of using ideas developed elsewhere in the group. For example, SBUs may prefer to manage their own personnel function (recruitment, training, etc.) rather than co-ordinate these activities with other SBUs. This preference will also extend to treasury matters and many treasurers have stories of SBUs that want to 'keep their own cash', 'keep their own banks' and so on. Those sorts of SBU can take a lot of management time.

There is also the issue of compulsion – should SBUs be required to trade with each other in preference to the market at large? If so, at what price? Again this is an issue for internal governance – what approach best supports the overall shareholder value of the group? Ultimately the rules have to be set by head office, even if the rule is for a 'free market'.

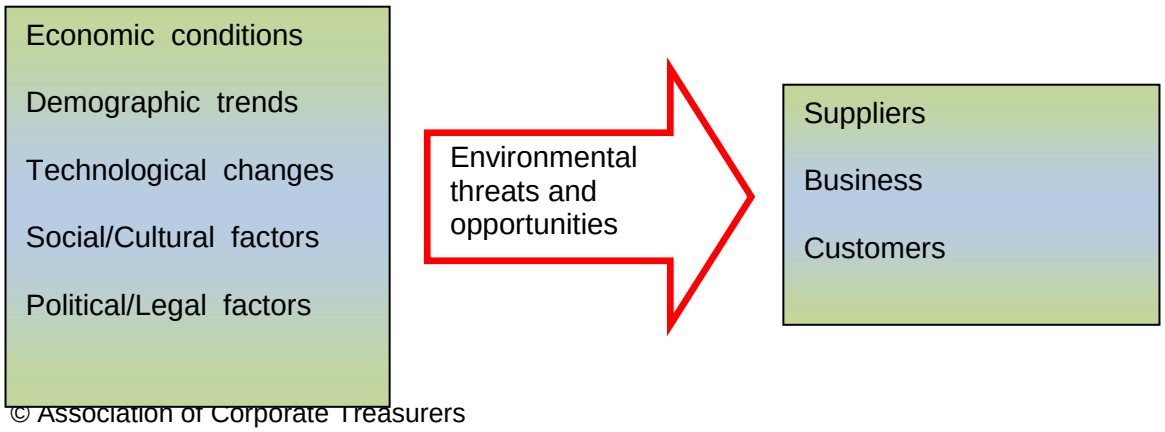
3 Economy level models

3.1 Model 1 – Environmental impact matrix (PEST)

PEST stands for four key factors (Political, Economic, Social, Technological) which influence the wider environment beyond the immediate surround of the individual business/industry. These and other factors form a continuously changing web of overlapping influences which work on the business itself and on its customers and suppliers, and which are outside the control of the firm. Anticipating such changes is how billionaires are created. Failing to anticipate them is how even the longest-established businesses fail.

Note that the term PEST is potentially misleading as the environmental factors are NOT necessarily limited to the 'classic' four. Some analysts have added Legal and rearranged the mnemonic to SLEPT. Others include Environmental factors expanded it to PESTEL or PESTLE. The model has been further extended to STEEPLE and STEEPLED, adding Ethics and Demographic factors. More recently, the growing importance of environmental or ecological factors have given rise to green business and we see STEER analysis: Socio-cultural, Technological, Economic, Ecological, and Regulatory factors. Take your pick. We will consider some of the most commonly cited environmental factors below.

Exhibit 2: Environmental factors



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Each factor can be characterised by potentially significant variables. See the examples below:

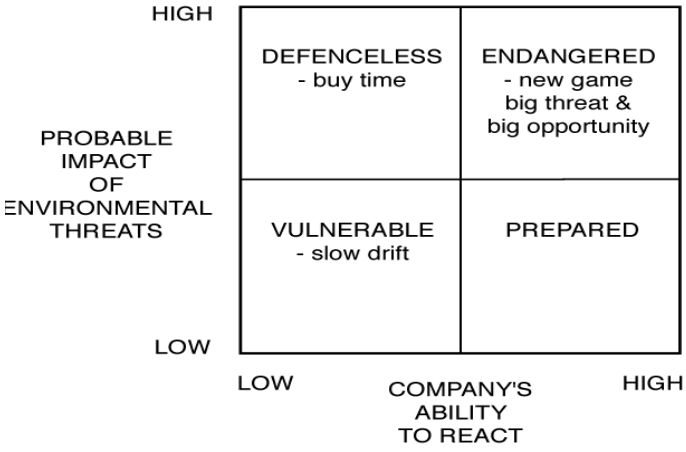
Economic Conditions	**Demographic Trends**	**Technological Changes**	**Social/Cultural Factors**	**Political/Legal Factors**
GNP Trends	Growth rate of population	Government spending on R & D	Lifestyle changes	Environment protection laws
Interest Rates	Age distribution	Industry spending on R & D	Career expectations	Changes to tax laws
Money Supply	Regional shift of population	Focus of technological efforts	Consumer activism	Special incentives
Inflation Rates	Life expectancies	Patent protection		Foreign trade regulations
Unemployment level	Birth rates			Banking regulations
Wage/price controls FX rates				Pension regulations
Energy availability				MiFiD / EMIR etc.

For instance, rising unemployment levels may indicate falling consumer spending levels. Longer life expectancies may indicate greater demand for health-care services. Focus of technological effort on combining communication and entertainment is changing what and how people buy. Lifestyle changes transform patterns of consumer spending. Environment protection, and “health and safety” laws radically alter the economies of a particular manufacturing process or service industry.

So, what does this mean for the firm?

The probable impact of environmental shifts combined with the company’s ability to react can be represented in an Environmental Impact Matrix. This provides a broad measure of the threat / opportunity which is the key to the firm’s long term success or failure, together with an indication of what the company needs to do about it.

Exhibit 3: Environmental impact matrix



4 Industry level models

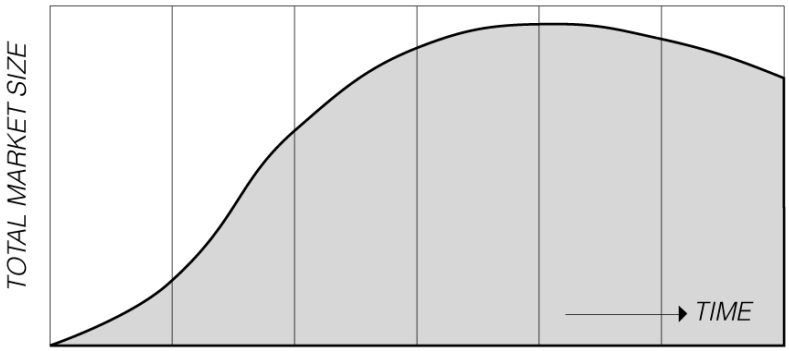
The next two models focus on market characteristics that set the framework for the nature of competition and how it is managed. The first uses stages in the market life-cycle as a focus for typical market-management scenarios. The second (Market Environment Matrix) uses the basis of competition and availability of economies of scale to do the same. The models should prompt you to ask the right questions about an industry.

4.1 Model 2 – Market life-cycle (MLC)

The concept underlying the use of the MLC is that most markets go through predictable patterns of development, growth, maturity and decline. Central to this concept is the principle that each stage of the MLC requires particular strengths from a company and its management if it is to be successful.

A word of warning: the MLC is sometimes referred to as the ‘product life-cycle’ – implying that the curve applies to ‘products’ rather than industries. This could lead to using the MLC model incorrectly. Although organisations do participate in markets by virtue of their product offerings, it is the market or industry we are assessing rather than the viability of a company’s particular presence in it. Based on a sound assessment and understanding of the MLC, a firm should be able to assess how likely it is that it would be able to maintain a competitive advantage over other participants in the industry.

Exhibit 4: Market life-cycle



Stage	*Developm't*	*Growth*	*Shakeout*	*Maturity*	*Saturation*	*Decline*
Market growth rate	*Low*	*Very high*	*High but slowing*	*GNP growth*	*Population growth*	*Negative*
No of segments	*Very few*	*Some*	*Some or many*	*Variable*	*Fewer*	*Few*
Techno-logical change in product	*Very great*	*Great*	*Medium*	*Little*	*Slight/break-through*	*Slight*
Techno-logical change in process	*Slight*	*Medium*	*Very great*	*Medium*	*Slight*	*Slight*
Functional emphasis	*R&D*	*Engin-eering*	*Production*	*Marketing & distrib'n*	*Accounting & finance*	*Finance & exits*
Business skills	*Product launch & Quality Control*	*Distribution & brand manage-ment*	*Dealer re-lationship Customer loyalty*	*Cost improving features*	*Cost*	*Exit*

We can drill into the implications of each stage for the organisation.

Development stage

The market here is in its embryonic stage. A single firm may have developed a new product (e.g. the Compact Disc which was originally developed solely for sound recordings – although Philips and Sony will probably always disagree on who got there first!) which it is offering for sale. The firm may have only a 'gut feel' about who the customers for the product might be and in what form they would want the product. Because it is new, the product may well be un-differentiated. The customers are early adopters, and so are unlikely to be price sensitive.

Key organisational strengths:

- Research & development
  - product innovation
- Product introduction skills
  - ability to educate customer
  - ability to gain early use
- Product quality
  - fast correction of defects
  - flexibility in altering products

- Financial characteristics
  - venture equity, losses, volatile, negative cash flows

Growth stage

As a market develops, sales grow and new competitors are attracted to the market. In some markets, the products of all competitors may be very similar, with the danger of a commodity market developing as has happened with writeable CD storage media. Competitors may start to differentiate their particular product with the introduction of printable and Lightscribe CDs for example.

Key organisational strengths:

- Engineering of product for efficient volume production
  - Brand management skills
  - create product recognition in an increasingly crowded market
- Effective distribution system
- Cash and human resources to cope with rapid growth
- Financial characteristics
  - heavy financing and investment, - equity plus some debt, low dividends, fast-growing but volatile profits, negative cash flows, investment appraisal and working capital control are critical

Shake-out stage

As the size of the total market begins to stabilise, less efficient competitors are forced out due to their difficulty in producing the product to a market price. Customers are more price-sensitive and ready for product differentiation/market segmentation. In the CD industry, manufacturing was outsourced and consolidated early on. However, there was still a proliferation of choice for the consumer from OEM suppliers such as Sony who tried to differentiate their products, even though they had contracted out manufacture.

Key organisational strengths:

- Production management
  - capacity to meet market demand
  - production efficiency to meet market-set pricing
  - appropriate level of quality built into product
- Deepening market relationships
  - cementing links with dealers and distributors
  - developing customer loyalty
- Financial characteristics
  - mix of debt and equity, need for differentiated product costing and pricing, economies of scale to be pursued, acquisition of smaller competitors, balance between dividends and capital growth

Maturity stage

- The market is approaching its maximum potential. The primary competitors are well-established with customers, distributors and production capacity. Increasing market segmentation and product differentiation is typical. Customers are very price-sensitive, increasing the risk of commoditisation. Looking at our CD example, data CDs are now sold mainly on price, data transfer rates and capacity. There may be some quality

issues, but often these are perceived by customers loyal to brands. With few manufacturers, the reality is that the product is universal in quality.

Key organisational strengths

- Brand defence
  - communication and promotion: advertising
  - improving distribution channels
- Product improvement skills
  - marginal benefits
  - marketing led improvements, e.g. 'New & improved!'
- Cost advantages
  - cost / benefit analysis for major expenditures
- Financial characteristics
  - financial controls even more important, cash flows more stable and balanced, tax management, little re-investment, acquisition finance, increasing debt finance, increasing dividend pay-out

Saturation stage

The market is fully saturated with the product – everyone who wants one, has one. Market sales are due to replacement or consumption. Due to the well-established competitors already in the market it is unlikely that new entrants will be attracted. In the CD industry, manufacturing is now dominated by a few key players: RITEK of Taiwan is the world's largest CD / DVD manufacturer with a well-established contract manufacturing business for the OEM market; the Indian firm Moser Baer is the world's 2nd largest CD/DVD manufacturer and supplies to the world's top dozen brands. From 2011, they make media for Memorex, TDK, Verbatim, Sony & Agfa-Gevaert. Note that despite the limited number of actual media manufacturers, there continue to be many different brands available to customers, underlying the power of brand loyalty and marketing.

Key organisational strengths:

- Brand management in decline
- Pursue cost advantages relentlessly
- Focus on financial controls
- Financial characteristics
  - Cost control is paramount, cash flows stable and strong. Low investment but minimum maintenance capex is crucial. Tax management, maximum dividend pay-out. Maximum leverage to minimise cost of capital and tax payment. Return equity to shareholders.

Decline stage

Market growth is negative or, at best, static. If the market is for a 'necessity' (e.g. drinking water) the life cycle curve is probably a straight line going on ad infinitum. Other markets may have a more pronounced decline (e.g. vinyl records, audio tapes, trans-Atlantic passenger liners). Looking again at our example, data CDs have been superseded by DVDs, cheap hard drives, increasingly cheap USB devices and flash drives and cloud technology.

Key organisational strengths

- Exit strategies
  - investigate alternative use of production facilities
  - sale of production facilities
  - sale of business as a ‘going concern’
  - closure
- Financial characteristics
  - Cost control - manage for return on assets. Strip out all cash. Return maximum dividends and surplus capital to shareholders

4.2 Model 3 – Market environment matrix

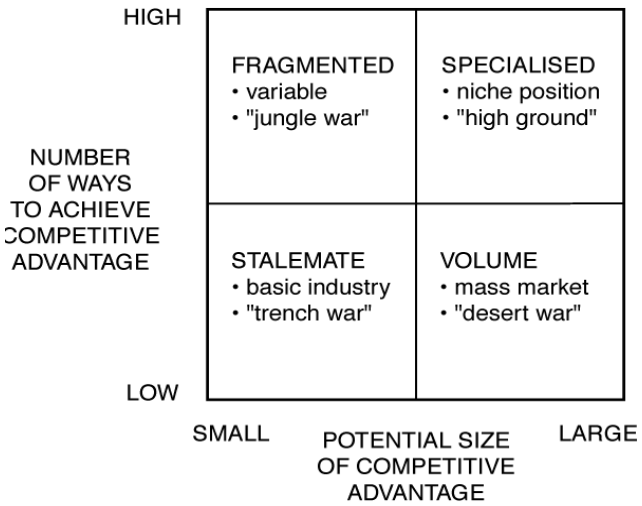
The market environment matrix is another method of classifying markets based on the dynamics of competition. Markets are characterised by two dimensions:

1. The number of ways to achieve competitive advantage, and
2. The potential size of competitive advantage

Plotted as a Market Environment Matrix, this results in four main classes:

1. Fragmented
2. Specialised
3. Stalemate
4. Volume

Exhibit 5: Market environment matrix

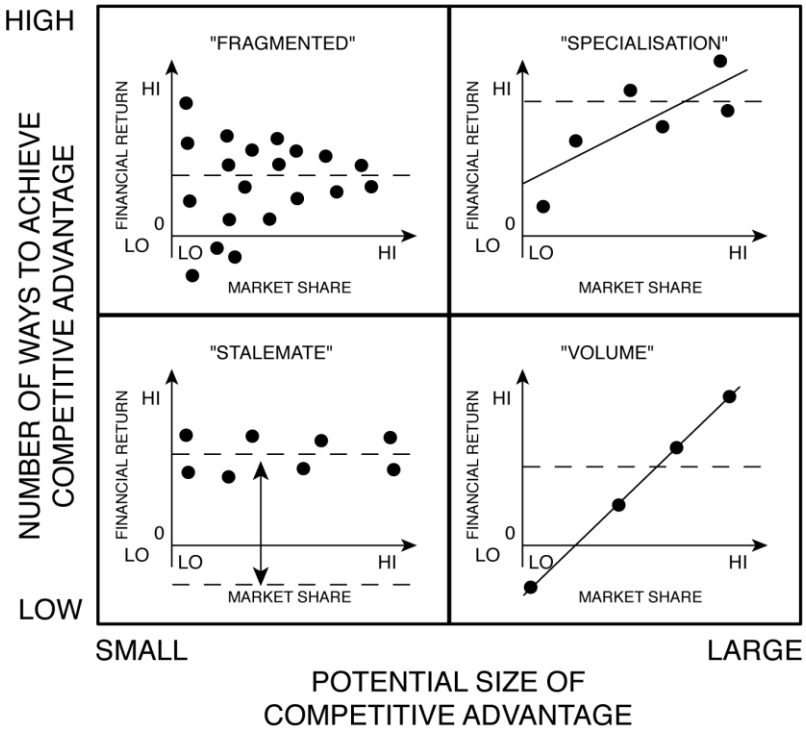


There are few ways to obtain competitive advantage other than price in Stalemate and Volume markets. This usually implies lowest-cost competition. On the other hand, for Fragmented and Specialised markets, differentiation by all kinds of means is possible.

For Fragmented and Stalemate markets, the possibility of economies of scale or economies of scope is limited. (Economies of scope mean that size does not directly reduce costs but enables you to do business not available to the smaller or geographically constrained business.)

The figure below indicates how financial return might vary with market share within each category, with regard to both level and volatility:

Exhibit 6: Financial return and market share



4.2.1 Characteristics of each segment of the market environment matrix

We set out below typical descriptors which characterise firms operating in each of these sectors, looking at cost and balance sheet implications, profitability, market share, critical success factors, organisation and management issues and key risks. These should help you in categorising firms (or SBUs) using this approach.

Fragmented

Populated by many small to medium sized firms, fragmented industries are found in many areas of the economy where competition is often local. Typical examples include restaurants, CTNs (confectionery, tobacconists and newsagents), market traders, handicrafts, small-holders, textile and footwear manufacturers, printers, metal fabricators, local distributors and light engineering firms.

- TYPICAL DESCRIPTORS
  - Market size varies
  - Competition often locally based
  - Many competitors/highly competitive
  - Low entry and exit barriers
  - Wide variety of product/service offerings
  - Short product life cycle
  - High degree of marginal innovation
  - Diverse and changeable customer needs

  - Price Sensitive - good service/response needed
- COST AND BALANCE SHEET
  - Low investment/working capital driven
  - Under capitalised, financed on overdraft
  - Low R&D, depreciation, overhead
  - Low marketing (but high level of impulse buying/customer knowledge)
  - Low added value
  - High labour cost (but not highly skilled/paid in the main)
  - Short term borrowing tends to be high
  - Often seasonality in investment cycle

- PROFIT
  - Variable returns
  - Levels of profitability are highly variable and unstable, but tend to 'bread and butter

- MARKET SHARE
  - variable market share benefits. High share can give advantages (local share, share by customer/product class etc) but size can give "diseconomies" of scale which compromise critical success factors - the cost of complexity, co-ordination and control

- CRITICAL SUCCESS FACTORS
  - Focus
  - Improving quality moving to specialist
  - Standardising; unlocking scale benefit, moving to volume if fragmented
  - Tight control of working capital & labour
  - Fast response to market opportunity/customer needs/keeping proximity to customers/being flexible
  - Seeking competitive edges in price/quality

- ORGANISATION/MANAGEMENT
  - 'Family' based organisation style
  - Simple management; close knit, good communications; flexible; adaptive; high commitment
  - Able to spot opportunities in industry, build customer relationships
  - Large companies: 'down size' (flatten), seek to franchise, go specialist/volume

- KEY RISKS
  - Management succession a major concern
  - Unable to maintain flexibility/response to changing customer needs
  - Lose ability to be a good operator
  - Other strategic groups begin to dominate

Specialised

The premium end of many industries (even or especially commodity industries) has a specialist segment. Typically we think of consumer luxury status goods like Rolex, Ferrari, Dior and Chanel compared to 'commodity' clothes, watches, travel goods etc. Other types of

specialists are frequently found in the people skills areas (design, consulting) and in high R&D/technology environments (Formula One, pharmaceuticals). The niche position might equally be a function of tradition.

- TYPICAL DESCRIPTORS
  - Small, highly segmented market
  - High gross margin/value added
  - High perception of product/service quality
  - Not highly price sensitive
  - Strong brand perceptions; intangible assets
  - Few market players
  - Customised
  - Selective/exclusive distribution
  - Restricted customer base - dependent on nature of specialist but typically requires:
    - Expensive/well qualified staff
    - R&D/product innovation capability
    - Strong marketing presence
    - High segment/customer specific investment
    - Very profitable beyond break-even needed to cover segment-specific costs

- PROFIT
  - Very attractive earning potential
  - Customer loyalty/price insensitive
  - “Roller Coaster” - very good/very bad

- MARKET SHARE
  - Market critical within selected segment
  - in order to spread segment-specific costs
  - Danger of segment moving into volume, brand devalues if volume becomes too great.

- CRITICAL SUCCESS FACTORS
  - High perceived product quality “better than the best”
  - Maintaining added value
  - Avoiding brand dilution
  - Keeping focus
  - State of the art
  - Locking in key staff/drivers of quality
  - Brand quality, exclusivity, image, distribution

- ORGANISATION/MANAGEMENT
  - Strong charismatic
  - Clear focus
  - Professional
  - Customer driven
  - Adaptability
  - Team/cell structure

- KEY RISKS
  - Obsolescence
  - Not being up to date
  - Loss of focus
  - Ability to control cost/quality (get to break even)
  - New entrants (volume competitors trade up)
  - Customers become more price sensitive
  - Counterfeits
  - Recession

Stalemate

Sometimes referred to as the "scrap industry sector", Stalemate includes basic industries such as steel, shipbuilding, petrochemicals, refining, aluminium, pulp, paper, etc. Other examples include float glass, bricks, tyres, cement, commodity mineral and food products.

- TYPICAL DESCRIPTORS
  - Large, well established market
  - Often cyclical, tied to all levels of economic activity
  - Homogeneous-commodity product
  - Repeat well educated buyers
  - Competition on price, low switching costs
  - Reliable service and supply
  - Well developed distribution infrastructure to break bulk or direct
  - In deregulated markets tend to be many competitors but often national champion

- COST AND BALANCE SHEET
  - Low level of R&D, marketing, overhead/administration, labour as a percentage of cost
  - High percentage on factor input costs (materials, energy)
  - High investment especially in fixed assets (high break-even)
  - Minimum economic increment tends to be +/- one production unit (NB with one plant/location most scale effects are exploited)
  - High entry & exit barriers

- PROFIT
  - Profit a feast or famine
  - When supply exceeds demand prices tend to weaken

- MARKET SHARE
  - May be of little help (economies of scale already exploited with one plant) all competitors earn high or low profit; difficult to get cost advantage on "commodity" factor input costs
  - But may give network benefits which spreads risk and helps capacity utilisation

- CRITICAL SUCCESS FACTORS
  - First question: to invest or not invest

- Tight cost control/efficiency
- Good assets, high utilisation, technology advantages
- Obtaining an edge on factor input costs/control of supply
- Market collusion
- Geographic strength
- Consistency, reliability

- ORGANISATION/MANAGEMENT
  - Centralised, efficiency, close control
  - Bureaucratic, hierarchical, procedural

- KEY RISKS
  - Supply exceeds demand
  - Recession
  - Too much capacity addition
  - Major technological discontinuity
  - Government risk/de-regulation
  - Union difficulties
  - Exchange rates/subsidies/tariffs. Critical to look at relative cost, utilisation linked to market environment

Volume

Branded consumer durable and non-durable household names immediately spring to mind. Coca-Cola (beverages), Nike (sportswear), Pedigree (Pet-foods), Kellogg's (cereals), McDonald's (fast-food). On the industrial front IBM (mainframes), Intel (chips), Boeing (aircraft manufacture), Samsung, LG, Sony, Panasonic, Apple, etc.

- TYPICAL DESCRIPTORS
  - Mass market, large sales volume
  - Standardised products
  - Homogeneous customer needs
  - Mass repetitive manufacture
  - Mass distribution - huge infrastructure
  - Dominated by few large competitors
  - Strong brand names
  - High levels of discretionary expense, ie Marketing and/or R&D
  - Major economies of scale
  - Major economies of scope (cost sharing across a range of products)
  - Big stakes game - high investment in P&L and B/S
  - Often rapid stock turnover (buyer power plus mass distribution - control of backward and forward integration)

- PROFIT
  - attractive return for a high share competitor (note – a retailer would expect : low return on sales, high return on assets; for a manufacturer : high return on sales, low return on assets)

- MARKET SHARE
  - Market share critical
  - For economies of scale & scope
  - Gives 'virtuous circle': spend more: better brand: increase share: more scale effect, reducing per unit cost

- CRITICAL SUCCESS FACTORS
  - Market share (No.1)
  - Financial power, commitment to 'kill' other competitors
  - Maintain leading brand
  - Control distribution
  - Satisfy mass customer market needs (often sets fashion)
  - Scale economies also give lowest cost status
  - 'Surprising Quality' - value for money

- ORGANISATION/MANAGEMENT
  - Centralised
  - Power/Formula approach
  - Often strong sales force/marketing to control distribution
  - Tight control (routine/like clockwork)

- KEY RISKS
  - Change in customer taste ('market segments')
  - Competitors 'leapfrog' with new products
  - Major technology change
  - Loss of brand/distribution. etc, that erodes market share
  - Power strategy collapses

Note that a company may operate across such 'pigeon-holed' classifications, which also can blur. The automotive industry is a case in point, where the mass market is spread across the Stalemate / Volume classes (depending on your point of view), and as an industry essentially makes its money from the specialised luxury / sporting end of the market. And despite the predominance of the automotive giants, niches exist – for instance in the sports car segment independent fragmented manufacturers include companies such as Morgan (UK) and Alpina (Germany). The multinationals all seem to avoid this area because they want a strong international presence, but that said both Morgan and Alpina have strong international brands.

5 Forum exercise[2]: Market life cycle

Think about the markets in which your own firm operates. Which stage of the MLC is most appropriate? You might find it helpful to consider other industries, e.g. mobile phones, televisions, automobiles. Bear in mind that markets are differentiated. For example, the

[2] You are expected to post forum activities to the appropriate forum within the two-week timeframe of the module. Please see the study timetable for reference.

mobile phone market for voice is probably saturated in Western Europe, but the mobile data market is probably in the growth to shakeout phase. Is this likely to be the same in West African markets?

Post your thoughts and reasons about your firm's position in the Market Life Cycle in the module forum: create a new post in the *Forum exercise from 1.3.1 Strategic and economic analysis* category with the title U1/M1/1.3.1/Market Life Cycle/[Your name] /[Company Name].

6 Competition level models

Understanding a firm's competitive position means, first, understanding the flow-through of product, then the relationships between competitors, suppliers and customers and the so-called "value chain". An informed assessment of these competitive characteristics provides an insight into the question of how to judge the potential profitability of any industry.

Not all industries offer similar rates of return. Some industries offer much higher levels of profitability than others. For example, traditionally, the tobacco industry has been a highly profitable one, while textiles have provided a much lower return. These relative rates of return are not due to historical accident but are determined by the characteristics of the industry. We present two models to help you focus down closely on a particular firm's value drivers.

6.1 Model 4 – Porter's five forces

A useful framework to diagnose competition in an industry is the 'Five Forces of Competition' model developed by Michael Porter of Harvard University. Porter found that the rate of return on investment (ROI) in any industry was determined by five sources of competitive pressure. If all five were adverse then it would be time to do something different for a living!

Among Porter's five forces were three sources of 'horizontal' competition:

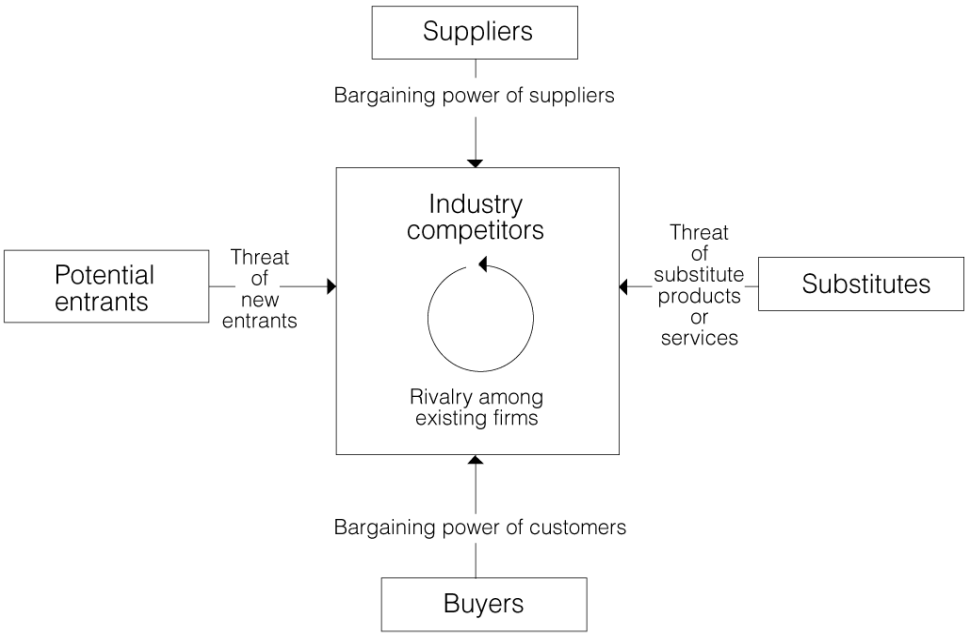
1. competition from established producers,
2. the threat of competition from new entrants, and
3. competition from the suppliers of substitutes.

The two remaining forces of competition are 'vertical':

4. the bargaining power of suppliers and
5. the bargaining power of customers.

Graphically, the model is illustrated below.

Exhibit 7: Porter's Five Forces of Competition



Looking at each of these five forces in turn:

Rivalry among existing firms

The intensity of rivalry among already existing competitors can create price wars, advertising battles, new product lines, and higher quality of customer service. This competitive force in a market is determined by:

- Many balanced competitors. An industry's competitor rivalry is increased if there are numerous competitors or if the competitors are equally balanced. Numerous competitors can create a strain on raw materials and competition for the same consumers. If also balanced, there is also a struggle for market leadership.
- A slow rate of market growth. Because the market is growing slowly, companies in a slowly growing industry must compete for market share in order to increase sales.
- Undifferentiated products or no switching costs. If the industry's product is not differentiated, buyers base their purchasing decision purely on price or quality of service. Likewise, if no switching costs are involved, buyers can play competitors against each other and obtain a lower price.
- High fixed or storage costs. High fixed costs resulted in an economy of scale effect that increases rivalry. When total costs are mostly fixed costs, the firm must produce near capacity to attain the lowest unit cost. Since the firm must sell this large quantity of product, high levels of production lead to a fight for market share and results in increased rivalry. High storage costs or highly perishable products cause a producer to sell goods as soon as possible. If other producers are attempting to unload product at the same time, competition for customers intensifies.
- Large increments of capacity. If capacity can only be increased in large amounts, then

any increase in capacity is likely to lead to oversupply and increased rivalry.

- High exit barriers. High exit barriers cause a firm to remain in an industry, even when the venture is not profitable. Competitors will be forced to 'slug it out' to survive. If an industry has specialised assets, high fixed costs associated with exit, strategic relationships among the particular business unit and others within the same firm, emotional barriers, and other pressures from a social point or government aspect; then the firms in the industry may compete, despite low earnings.
- Diversity of rivals. The more diverse a firm is (ie operates in many different industries), the more able such a company will be to withstand periods of intense competition in one market – since their other markets should be more profitable.

Threat of new entrants

Barriers to entry, or the possibility that new entrants will be deterred from entering a market, are determined by:

- Economies of scale. Economies of scale reduce the per-unit cost of a product as the number of units being produced increases. A significant economy of scale entry barrier often exists in industries with a high production output. If a new entrant wanted to enter the market, it would have to enter the market producing a large quantity at the same low price as existing competitors or it would have to compete with a cost disadvantage. If economies of scale exist in an industry, they deter smaller competitors (in particular) from entering into the market and reduces the threat of new entrants.
- Product differentiation. Established brand names and customer loyalty create a considerable entry barrier for new entrants. New entrants must increase spending to overcome the reputation and large customer base of the existing companies.
- Capital requirements. Large capital requirements create an entry barrier for new entrants because it requires them to have a significant source of capital to get started. The greater the amount of up-front investment a firm has to make (in terms of manufacturing capacity, inventory, etc) to enter a market, the more risky (and less attractive) a market will be. The large capital investment entails costs not only for production equipment, but also for labour, raw materials, and research and development. In addition to these costs, a new company would need to spend a large amount of money on advertising and marketing to overcome product differentiation.
- Switching costs. This applies to both customers and suppliers. Both may incur costs in switching to a new entrant, e.g. a customer may have to pay to exit a contract and a supplier may have to meet certain standards.
- Access to distribution channels. If existing competitors have 'locked in' the traditional channels of distribution for the product, a new entrant will be forced to find alternative means of distribution.
- Cost disadvantages independent of scale such as patents, favourable access to raw materials, government subsidies and polices which create barriers of entry for new companies. For example, there may exist in some industries restrictions regarding how many competitors there are. These restrictions may be "limitation by number" (eg electricity generators, water companies) or by setting strict licensing standards (eg banking).
- Expectation of retaliation. A major concern for any potential new entrant will be the potential aggressiveness of existing competitors in defending their marketplace. Existing

competitors could reduce their prices or provide customers with special offers thus limiting the short-run profitability of a new entrant. If that new entrant does not have sufficient capital to withstand losses over the short to medium term, then they will disappear without a trace.

Threat of substitutes

The threat of substitute products is a competitive force that can set a ceiling on the price the industry can charge for their product. If there are substitutes available to the consumer, an industry's potential returns are limited.

Although it is often difficult to imagine a pure substitute for a particular product or service, it can be a real competitive threat. For instance audio CDs substantially (but not entirely) killed the market for vinyl records, and in turn today's audio CD market is under major threat from downloadable MP3s.

Substitutes are a competitive threat if they meet the following criteria:

- They offer lower cost or better value through technological innovation.
- They perform the same 'function' but from an entirely different market.

Although there are not always perfect substitutes, many do exist. Consider for example, the different modes of crossing the English Channel; the different fuels for power generation; use of aluminium, steel, glass and plastics in the packaging industry.
While the threat of substitutes generally acts as a price constraint, there can be other concerns in assessing the threat of substitutes. Consider TV transmission where traditional "free" transmission now competes with cable and satellite. The new technologies enable the bundling of additional services without which cable and satellite might not be able to compete on price alone.

Bargaining power of suppliers

The ability of suppliers to dictate price, quality, credit and delivery terms to firms operating in a particular industry will exert a strong influence on the degree of competition within that sector. One example is the dominance of the Big Four practices in providing audit services to multinationals. Generally, suppliers are powerful if:

- They are relatively few in number. If there are only one or two potential suppliers of a service or raw material, they will have the ability to dictate terms of trade.
- Supplier power is also increased if the industry is not an important customer of the supplier.
- The raw materials or services which they supply are key components of the final product and there are no substitutes or switching costs are high.
- There is a credible possibility that they could use their control of essential raw materials or services to forward integrate and become competitors as well. This type of competitor could be particularly dangerous since they will control the cost and availability of raw materials or services to their competitors.

Bargaining power of customers (buyers)

The relative power of a firm's customers in dictating price, quality, credit and delivery terms is the converse of supplier power – a typical example is the supermarket chain. Generally, customers will have the upper hand if:

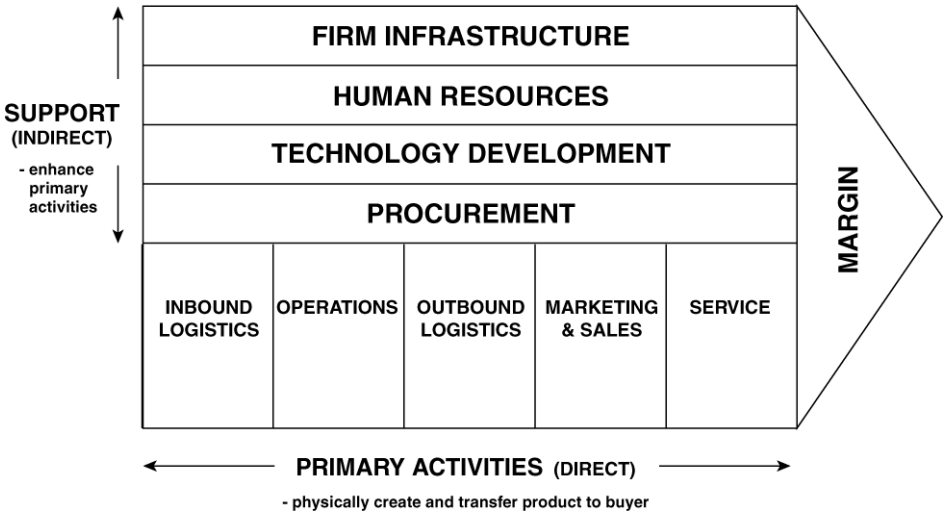
- there are relatively few customers in the market compared to competitors
- if a buyer represents a large proportion of sales, the buyer has bargaining power and will probably be able to negotiate substantial discounts.
- if the product is undifferentiated and / or there are low switching costs, buyers will be able to play off one supplier against another.
- if the quality of the customer's product is not affected by the quality of the supplier's product. Effectively, the buyer can be more cost conscious.
- there is a credible possibility that the customer could undertake backward integration and acquire their own source of supply.

6.2 Model 5 – Value chain analysis

Value chain analysis originated as an accounting tool to identify how much value was added at successive stages in the production process. The analysis helped to show where cost improvements or value creation improvements could be best made.

Michael Porter used the analysis to help isolate the basis for a firm's competitive advantage. He distinguished between primary and support activities:

Exhibit 8: The value chain



Primary activities

- Inbound logistics: activities concerned with managing raw material inputs,
  - e.g. warehousing, goods movement, stock control.
- Operations: activities concerned with transforming raw materials into product,
  - e.g. processing, assembling, packaging.
- Outbound logistics: activities concerned with releasing the product to the buyer,
  - e.g. storing, dispatching, invoicing.
- Marketing & sales: activities concerned with publicising and selling the product,

  - e.g. advertising, sales force.
- Service: activities concerned with the firm-buyer interface during and after delivery.
  - e.g. point-of-sale service, maintenance

Secondary activities

- Firm infrastructure: the structures within which primary activities function, e.g. organisation structures, accounting and finance, management information systems
- Human resources: the recruiting, management, motivation and development of staff.
- Technology development: the development of the knowledge and skills (not necessarily "engineering") which underpin operations.
- Procurement: activities concerned with acquiring the inputs to the process. In a service industry this may be largely recruitment of staff, so it would overlap with Human Resources.

Using value chain analysis

Value chain analysis is a systematic process for auditing a firm's competitive advantage comprising the following stages:

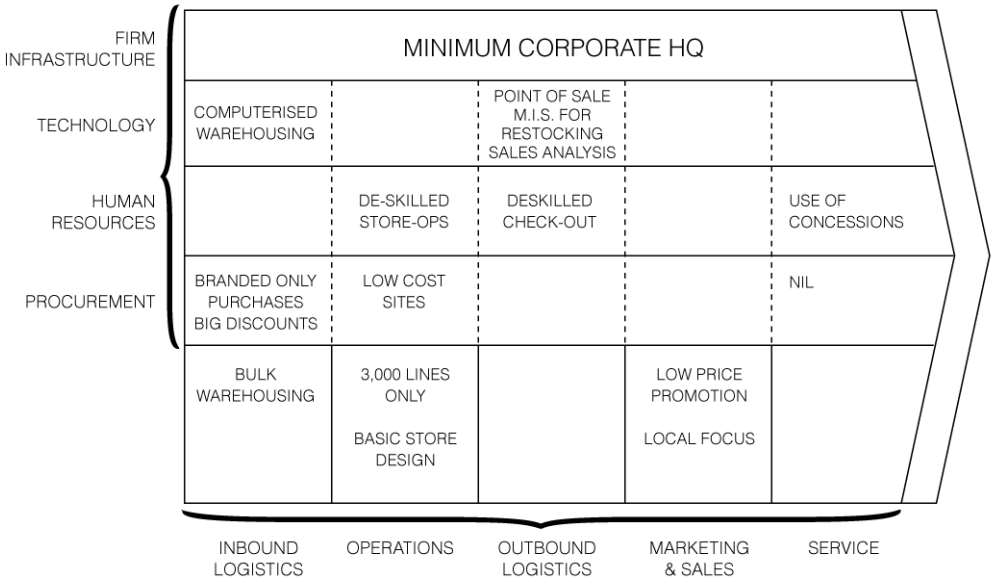
- Describe the flow of direct activities in a business (input/conversion/sale/support).
- What are the key activity stages in the chain?
- For each activity stage list the key determinants for gaining:
  - cost advantage
  - differentiation advantage
- How does the firm measure up against the factors for success identified in steps 2 and 3?
- How well do "indirects" support "directs"? e.g.
  - functional management
  - human resources/organisation
  - technology
  - finance, etc.

Study example

Lo-Price is a cut-price grocery chain. Its ability to compete with the major grocery multiples depend on a cost competitive strategy, which is sustained throughout the value chain.

Lo-Price's strategy is based on ability to provide low-priced goods supported by a low-cost operation. The whole of the operation is designed for this purpose. The flow chart below sets out the flow of activities and some of the key stages in them.

Exhibit 9: Lo-Price Linkages throughout the value chain



Now analysing each activity:

Stage	Cost advantage	Differentiation advantage
Inbound logistics	Because the policy is branded goods only, Lo-Price is able to obtain maximum discounts from manufacturers,	Discounts as good or better as large chains.
Operations	Store managers are required to keep to a simple and relatively de-skilled operation with branded goods only.	Complex areas of greengrocery and butchery are dealt with on the basis of concessions – i.e. Lo-price rents space to greengrocery or butcher specialists who run their own mini-businesses within the main store. Customers see low price branded goods with high quality concessions.
Outbound logistics	Bulk computerised central warehousing feeds stores with a limited number of “branded only” lines.	Out of stock incidents almost unknown. Reliability added to list of virtues.
Marketing and sales	Stores are basic in design and the approach to merchandising simple	Overall, the marketing approach of the store group is to promote a

		discount image to the local community
Service	Low cost compared to majors on a basket of goods	Reliability

Finally, the corporate headquarters is simple with few staff.

7 Company level models

Many observers have commented that firms appear better at analysing industries than they are at deciding how exposed they should be in them. Firms are usually restricted in the amount of capital and other resources which they can provide to their various markets (or SBUs). As a consequence, a number of devices have been created to help senior management make these difficult resourcing choices. One tool that has been developed to help in the strategic resource allocation problem is the product portfolio matrix (PPM).

7.1 Model 6 – BCG (Boston Consulting Group) product portfolio matrix

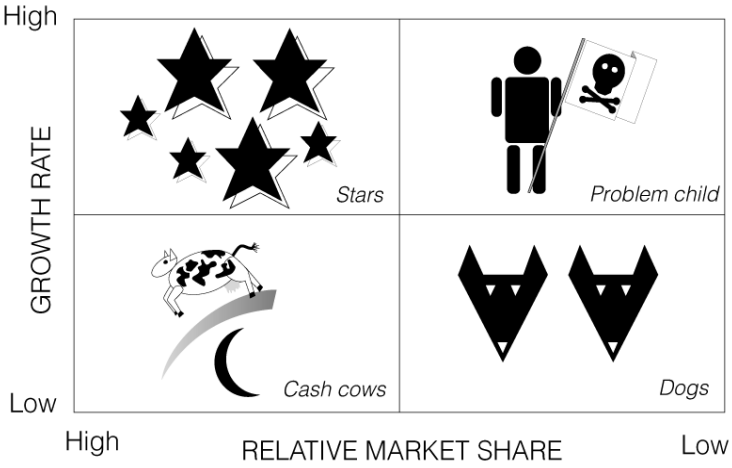
This model focuses on managing a portfolio of businesses based on their product-market and cash-flow characteristics. In a sense, it “piggy-backs” on the earlier analytical concepts and models, such as the market life-cycle. The product portfolio matrix (PPM) was developed in the early 1960s by the Boston Consulting Group. BCG had been hired by a number of very large US conglomerates to help them develop a process by which to allocate resources to their diverse Strategic Business Units.

The General Electric Company is a good example. In the early 1960s, GE found that they were operating in something like 700 different markets. GE had operations in markets as diverse as dishwashers, computers, nuclear electrical generators, missiles, and televisions. The people at the top of GE, who may have been exposed to only one or two parts of the entire organisation throughout their career, found it difficult to decide where to allocate resources and how much should be provided.

Based on research conducted by the Boston Consulting Group, a simple device was created. Essentially, they discovered that the key to long term success in any market was market share. Firms which had a relatively dominant position in a market were able to generate greater profits than those competitors with smaller market shares. As a consequence, the consultants advised GE to invest their resources in those (SBUs) where they held a relatively large market share and to withdraw from markets where it was unlikely that they could ever achieve a dominant market share.

To simplify matters even more, they offered a simple matrix (called the product portfolio matrix) with which a firm could classify their SBUs:

Exhibit 10: Product portfolio matrix (after Boston Consulting Group)



The vertical axis in the matrix is the market growth rate. If the growth rate of a market is expected to be about twice the rate of inflation, then the SBU would be situated in the upper half of the matrix. The horizontal axis refers to relative market share. If a SBU has at least 50 percent greater share of the market than its nearest competitor, then the SBU can be classified on the left hand side of the matrix. Incidentally, if an SBU had ten times the market share of their nearest competitor, the SBU would be classified as right up against the left-hand border.
Using the classifications above, an organisation can allocate all of their SBUs to the appropriate box of the matrix. The four boxes are:

Cash cows: These SBUs have relatively high market shares in markets that are fairly mature and stable. Due to their high market share and consequent pricing power, such SBUs should be generating surplus cash – above that required for working capital and reinvestment. Cash cows provide the stable earnings base, which supports the organisation. Typical examples include tobacco companies, utilities and supermarket chains. Cash cows might seem the ideal component of any business portfolio, but they do lack the growth that really improves shareholder value. However they can fund some of growth of other more promising lines of business.

Stars: These SBUs operate in a fast growing market (whether product or country) and have a strong market share. They will be highly profitable (due to market share) but they will also require a great deal of capital to invest in working capital and increased fixed assets. If these SBUs are expected to be able to retain market share, even when the market growth rate slows down, they should become the cash cows of the future. Examples include luxury carmakers in China, security systems (as opposed to general defence) worldwide, and the iPod at first launch, again worldwide.

Dogs: SBUs with a low market share in a stable, unexciting market are unlikely to provide sufficient cash to maintain themselves. As a consequence, they are likely to require continual cash injections from the parent company – but are unlikely ever to increase market share and repay the cash. The logical conclusion is that dog SBUs should be disposed of in an economically efficient manner. Examples include(d) Concorde, mainframe computers

and smaller (undifferentiated) restaurant chains.
Problem child (or Question mark): These provide the difficult resource decisions. Although the markets in which they operate are growing quickly, the SBU has not yet been able to attain sufficient market share to generate higher level of profits. The decision which must be taken is whether the SBU is ever likely to increase market share and become a 'star' and if not...'bow-wow'! Examples include any entrant to a new (expanding) market such as tablet computers or smartphones, or supermarkets seeking to expand into emerging economies.

Product portfolio implications
The location of an organisation's SBUs on the matrix is indicative of the current 'health' of the portfolio. The ideal portfolio would consist of a mix of cash cows and stars, the cows providing the cash to feed the stars. Once the market growth rate for the star SBUs slows, they should then evolve into the cash cows of the future, in turn funding future stars.

Note that management can convert SBUs between categories. Cash cows will generally represent the (desirable) steady state, and although Stars are likely eventually to become Cash Cows, they should not be allowed to become Dogs or Problem Children. Similarly good management or a change in ownership can upgrade the latter two into Cash Cows or even Stars. One example is a minority holding in Pakistan Petroleum Limited (PPL), which was a Dog under the ownership of (then) Burmah Castrol plc, and which was duly divested for tens of millions of dollars in the mid 1990s. In 2011 PPL is now worth over $2bn.
Symptoms of unbalanced portfolios:

- Too many dogs. Common characteristics would be:
  - inadequate cashflow
  - inadequate profits
  - Inadequate sales growth.

- Too many problem children. Although sales growth will be healthy (due to the high growth in the market) the SBU will experience:
  - cash flow difficulties
  - Inadequate profits.

- Too many cash cows. Profits generated will look healthy, however other areas of concern might be:
  - inadequate or static sales growth
  - excessive cashflow – with no SBUs which justify added investment.

- Too many stars. Profits should be good, sales growth should be healthy. There are some potential pitfalls, namely:
  - excessive cash demands. Stars require sustained investment to maintain their growing working capital requirements and to fund capacity increases
  - stretched management. Managing a fast growing, successful business takes a lot of time and effort in setting up financial controls, developing marketing and production skills and other general management concerns. Due to the pressures of fast growth, short cuts may be taken which could lead to disaster in the future.

7.2 Model 7 – Product market matrix

Another strategic choice model is the product-market matrix (PMM) devised by Igor Ansoff. By combining the options to exploit existing or new markets with existing or new products, four strategies are identified: market penetration, product development, market development and diversification, each with progressively increasing amounts of risk:

Exhibit 11: Product market matrix

PRODUCT / MARKET	PRESENT	NEW
PRESENT	MARKET PENETRATION	PRODUCT DEVELOPMENT
NEW	MARKET DEVELOPMENT	DIVERSIFICATION

Each strategy is characterised briefly below:

- Market Penetration Strategy
  - Growth achieved by winning additional business from competitors.
  - Lowest risk strategy:
    - knows the product
    - knows the market

- Product Development Strategy
  - Strategy of introducing new products into markets in which the company is already familiar.
  - Based on the assumption that the total market is shared amongst all products in the market – by offering a greater number of products, the company will gain additional market share.
  - Most relevant where product switching is a feature of buyer behaviour (low brand loyalty).
  - Risks:
    - costs of product development
    - costs of new product launch

- Market Development Strategy
  - Growth achieved by moving into new markets with existing products
  - Most often considered when existing markets offer relatively little growth prospects
  - Risks to consider:
    - lack of market knowledge and buyer behaviour
    - potential reactions by competitors in the prospective market
    - established products in the prospective markets may already dominate

- Diversification Strategy
  - To enter new markets with a new product
  - Usually achieved by acquisition rather than start-up
  - Strategy is adopted when new product development is unlikely to be effective and

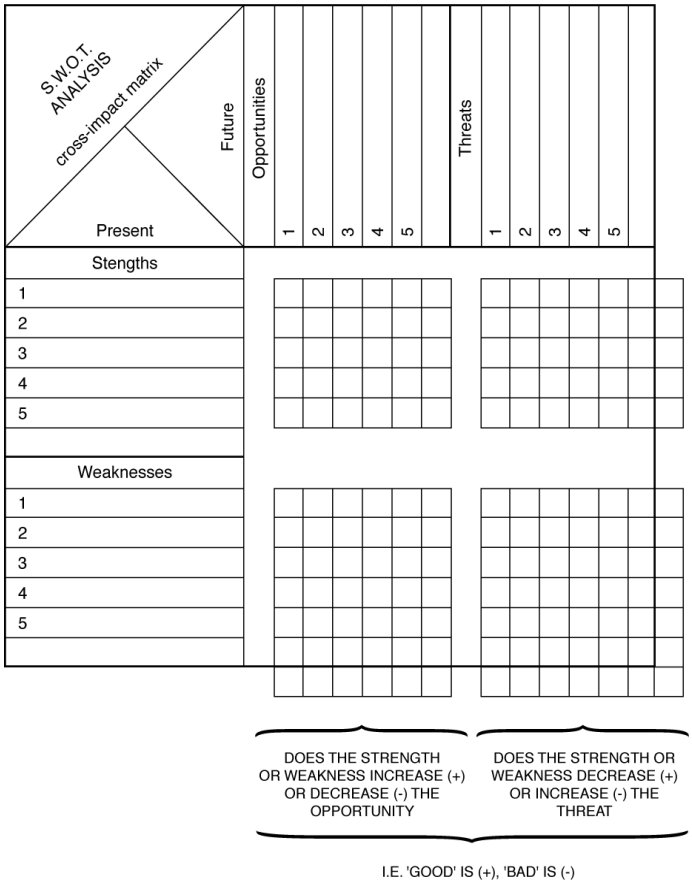
when the established market is static
- Highest risk
- Tends to be considered when there are some elements of synergy to the strategy
- Different kinds of synergy
  - Sales: utilising existing distribution channels or market position
  - Operating: spreading overhead costs and the cross-utilisation of production facilities
  - Investment: evening out of cash-flow cycles, sharing investment costs for new plant and facilities
  - Management: management skill, expertise and knowledge can be shared

8 General level models

8.1 Model 8 – SWOT analysis

SWOT (Strengths, Weaknesses, Opportunities & Threats) analysis is widely used at all levels in business as a systematic way of evaluating future opportunities and threats in terms of present strengths and weaknesses. SWOT analysis can be used at the economy, industry, competition or company level. As a practical tool it works best when done by several people on a brainstorming / discussion basis, with the results calculated on the form below. Like the previous model the fundamental analysis of the business needs to have been done beforehand – this is a device for summarising key features. That said, many corporations will use SWOT without explicitly considering any other models.

Exhibit 12: SWOT analysis



The steps in the analysis are:

- Identify the internal strengths and weaknesses which you perceive the company/business unit to have. Similarly, identify the opportunities and threats which you feel are likely to emerge in the future.
- Having entered the most important strengths and weaknesses on the enclosed SWOT form, assess the likely impact of each on the opportunities and threats you have identified.
- Scoring: If you think a particular strength may be helpful in taking advantage of an opportunity, assign it a positive score (+1 or +2, depending on your assessment of how it will impact the business) and if it is neither helpful nor unhelpful give a score of 0. Finally, if a strength or weakness inhibits the achievement of an opportunity, assign it a negative score. Some of the factors you will have identified can be strengths or weaknesses depending on the circumstances, eg exposure to exchange rates. In the SWOT analysis it should not be both. You have to decide if the factor is likely to be a strength or a weakness for the period under consideration.
- For threats, if a strength decreases the potential effect of a threat, assign it a positive score. Similarly, if a weakness increases the potential impact of a threat, assign a negative score.

For each strength and weakness, assess the impact on each opportunity and threat over a range +2 to -2 using the following weights.

+2	Very positive impact
+1	some positive impact
0	No impact
-1	some negative impact
-2	Very negative impact

The easiest way to complete the matrix is to take each opportunity/threat and to assess the likely impact of each strength and weakness which you have identified.