Industry Competition 3

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This chapter marks the beginning of the strategic management process and is one of two that considers the external environment. At this point it is appropriate to focus on factors *external* to the organization and to view firm performance from an industrial organization perspective. *Internal* factors are considered later in the process and in future chapters.

Industry
A group of competitors that produce similar products or services.

Each business operates among a group of companies that produces competing products or services known as an **industry.** The concept of an industry is a simple one, but it is often confused in everyday conversations. The term *industry* does not refer to a single company or specific firms in general. For example, in the statement, "A new industry is moving to the community," the word *industry* should be replaced by *company* or *firm*.

Although usually differences exist among competitors, each industry has its own set of combat rules governing such issues as product quality, pricing, and distribution. This is especially true for industries that contain a large number of firms offering standardized products and services. Most competitors—but not all—follow the rules. For example, most service stations in the United States generally offer regular unleaded, midgrade, and premium unleaded gasoline at prices that do not differ substantially from those at nearby stations. Breaking the so-called rules and charting a different strategic course might be possible, but may not be desirable. As such, it is important for strategic managers to understand the structure of the industry(s) in which their firms operate before deciding how to compete successfully.

Defining a firm's industry is not always an easy task. In a perfect world, each firm would operate in one clearly defined industry; however, many firms compete in multiple industries, and strategic managers in similar firms often differ in their conceptualizations of the industry environment. In addition, some companies have utilized the Internet to redefine industries or even invent new ones, such as eBay's online auction or Priceline's travel businesses. As a result, the process of industry definition and analysis can be especially challenging when Internet competition is considered.[1]

Numerous outside sources can assist a strategic manager in determining "where to draw the industry lines" (i.e., determining which competitors are in the industry, which are not, and why). Government classification systems, such as the Standardized Industrial Classification (SIC), as well as distinctions made by trade journals and business analysts may be helpful. In 1997, the U.S. Census Bureau replaced the SIC system with the North American Industry Classification System (NAICS), an alternative system designed to facilitate comparisons of business activities across North America. Astute managers assess all of these sources, however, and add their own rigorous and systematic analysis of the competition when defining the industry.

Numerous descriptive factors can be used when drawing the industry lines. In the case of McDonald's, for example, attributes such as speed of service, types of products, prices of products, and level of service may be useful. Hence, one might define McDonald's industry as consisting of restaurants offering easy to consume, moderately priced food products rapidly and in a limited service environment. Broad terms such as "fast food" are often used to describe such industries, but doing so does not eliminate the need for a clear, tight definition.

Some factors are usually not helpful when defining an industry, however, such as those directly associated with strategy and firm size. For example, it is not a good idea to exclude a "fast-food" restaurant in McDonald's industry because it is not part of a large chain or because it emphasizes low-priced food. Rather, these

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factors explain how such a restaurant might be positioned vis-à-vis to McDonald's, a concept discussed in greater detail in Chapter 7.

The concept of primary and secondary industries may also be a useful tool in defining an industry. A primary industry may be conceptualized as a group of close competitors, whereas a secondary industry includes less direct competition. When one analyzes a firm's competition, the primary industry is loosely considered to be "the industry," whereas the secondary industry is presented as a means of adding clarity to the analysis. For example, McDonald's primary industry includes such competitors as Burger King and Wendy's, whereas its secondary industry might also include restaurants that do not emphasize hamburgers and offer more traditional restaurant seating such as Pizza Hut and Denny's. The distinction between primary and secondary industry may be based on objective criteria such as price, similarity of products, or location, but is ultimately a subjective call.

Once the industry is defined, it is important to identify the **market share,** which is a competitor's share of the total industry sales, for the firm and its key rivals. Unless stated otherwise, market share calculations are usually based on total sales revenues of the firms in an industry rather than units produced or sold by the individual firms. This information is often available from public sources, especially when there is a high level of agreement as to how an industry should be defined.

Market Share

The percentage of total market sales attributed to one competitor (i.e., firm sales divided by total market sales).

When market share is not available or substantial differences exist in industry definitions, however, **relative market share,** or a firm's share of industry sales when only the firm and its key competitors are considered, can serve as a useful substitute. Consider low-end discount retailer Dollar Tree as an example and assume that the only available market share data considers Dollar Tree to be part of the broadly defined discount department store industry. If a more narrow industry definition is proposed—perhaps one limited to deep discount retailers—new market share calculations will be necessary. In addition, it becomes quite complicated when one attempts to include the multitude of mom-and-pop discounters in the calculations. In this situation, computing relative market shares that consider Dollar Tree and its major competitors can be useful. Assume for the sake of this example that four major competitors are identified in this industry—Dollar General, Family Dollar, Dollar Tree, and Fred's—with annual sales of $6 billion, $5 billion, $2 billion, and $1 billion, respectively. Relative market share would be calculated on the basis of a total market size of $14 billion (i.e., 6 + 5 + 2 + 1). In this example, relative market shares for the competitors are 43 percent, 36 percent, 14 percent, and 7 percent, respectively. From a practical standpoint, calculating relative market share can be appropriate when external data sources are limited.

Relative Market Share

A firm's share of industry sales when only the firm and its key competitors are considered (i.e., firm sales divided by total sales of a select group firms in the industry).

A firm's market share can also become quite complex as various industry or market restrictions are added. Unfortunately, the precise market share information most useful to a firm may be based on a set of industry factors so complex that computing it becomes an arduous task. In a recent analysis, the Mintel International Group set out to identify the size of the "healthy snack" market in the United States, a task complicated by the fact that many products such as cheese, yogurt, and cereal are eaten as snacks in some but not all instances.[2] To overcome this barrier, analysts computed a total for the healthy snack market by adding only the proportion of each food category consumed as a healthy snack. In other words, 100 percent of the total sales of products such as popcorn and trail mix—foods consumed as "healthy snacks" 100 percent of the time—were included in the total. In contrast, only 40 percent of cheese consumption, 61 percent of yogurt consumption, and 21 percent of cereal consumption were included

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Case Analysis 3-1

Step 2: Identification of the Industry and the Competitors

After the organization has been introduced, its industry must be specifically identified. This process can be either relatively simple or difficult. For example, most would agree that Kroger is in the "grocery store industry," and its competition comes primarily from other grocery stores. However, not all decisions are simple. For example, should Wal-Mart be classified in the department store industry (competing with upscale mall-oriented stores) or in the discount retail industry (competing with low-end retailers such as Family Dollar)? Is Taco Bell in the fast-food industry or in the broader restaurant industry? To further complicate matters, many corporations are diversified and compete in a number of different industries. For example, Anheuser Busch operates breweries and theme parks. In cases in which multiple business units are competing in different industries, one needs to identify multiple industries. Market shares or relative market shares for the firm and its key competitors—based on the best available data—should also be identified. It is important to clarify industry definition at the outset so that the macroenvironmental forces that affect it can be realistically assessed. In addition, a firm's relative strengths and weaknesses can be classified as such only when compared to other companies in the industry.

in the total. Although this approach is reasonable and can be quite useful, it can only be calculated when one has access to data that may not be readily available. Hence, analysts must use the best data available to describe the relative market positions of the competitors in a given industry (see Case Analysis 3-1).

3-1 Industry Life Cycle Stages

Industry Life Cycle
The stages (introduction, growth, shakeout, maturity, and decline) through which industries often pass.

Like firms, industries develop and evolve over time. Not only might the group of competitors within a firm's industry change constantly, but also the nature and structure of the industry can change as it matures and its markets become better defined. An industry's developmental stage influences the nature of competition and potential profitability among competitors.[3] In theory, each industry passes through five distinct phases of an **industry life cycle** (see Figure 3-1).

A young industry that is beginning to form is considered to be in the *introduction stage*. Demand for the industry's outputs is low at this time because product and/or service awareness is still developing. Virtually all purchasers are first-time buyers and tend to be affluent, risk tolerant, and innovative. Technology is a key concern in this stage because businesses often seek ways to improve production and distribution efficiencies as they learn more about their markets.

Normally, after key technological issues are addressed and customer demand begins to rise, the industry enters the *growth stage*. Growth continues but tends to slow as the market demand approaches saturation. Fewer first-time buyers remain, and most purchases tend to be upgrades or replacements. Many competitors are

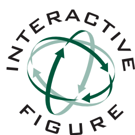
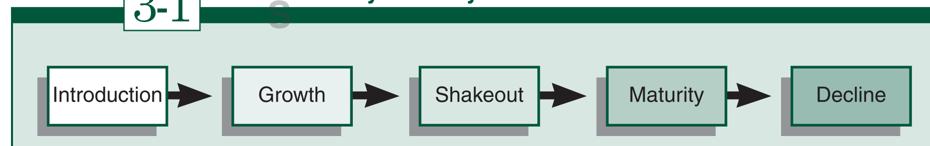


FIGURE 3-1 The Industry Life Cycle



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profitable, but available funds may be heavily invested into new facilities or technologies. Some of the industry's weaker competitors may go out of business in this stage.

Shakeout occurs when industry growth is no longer rapid enough to support the increasing number of competitors in the industry. As a result, a firm's growth is contingent on its resources and competitive positioning instead of a high growth rate within the industry. Marginal competitors are forced out, and a small number of industry leaders may emerge.

Maturity is reached when the market demand for the industry's outputs is completely saturated. Virtually all purchases are upgrades or replacements, and industry growth may be low, nonexistent, or even negative. Industry standards for quality and service have been established, and customer expectations tend to be more consistent than in previous stages. The U.S. automobile industry is a classic example of a mature industry. Firms in mature industries often seek new uses for their products or services or pursue new markets, often through global expansion.

The *decline stage* occurs when demand for an industry's products and services decreases and often begins when consumers turn to more convenient, safer, or higher quality offerings from firms in substitute industries. Some firms may divest their business units in this stage, whereas others may seek to "reinvent themselves" and pursue a new wave of growth associated with a similar product or service.

A number of external factors can facilitate movement along the industry life cycle. When oil prices spiked in 2005, for example, firms in oil-intensive industries such as airlines and carmakers began to feel the squeeze.[4] When an industry is mature, however, firms are often better able to withstand such pressures and survive.

Although the life cycle model is useful for analysis, identifying an industry's precise position is often difficult, and not all industries follow these exact stages or at predictable intervals.[5] For example, the U.S. railroad industry did not reach maturity for many decades and extended over a hundred years before entering decline, whereas the personal computer industry began to show signs of maturity after only seven years. In addition, following an industry's decline, changes in the macroenvironment may revitalize new growth. For example, the bicycle industry fell into decline some years ago when the automobile gained popularity but has now been rejuvenated by society's interest in health and physical fitness.

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3-2 Industry Structure

Factors associated with industry structure have been found to play a dominant role in the performance of many companies, with the exception of those that are its notable leaders or failures.[6] As such, one needs to understand these factors at the outset before delving into the characteristics of a specific firm. Michael Porter, a leading authority on industry analysis, proposed a systematic means of analyzing the potential profitability of firms in an industry known as Porter's "five forces" model. According to Porter, an industry's overall profitability, which is the combined profits of all competitors, depends on five basic competitive forces, the relative weights of which vary by industry (see Figure 3-2).

1. Intensity of rivalry among incumbent firms
2. Threat of new competitors entering the industry
3. Threat of substitute products or services
4. Bargaining power of buyers
5. Bargaining power of suppliers

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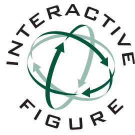
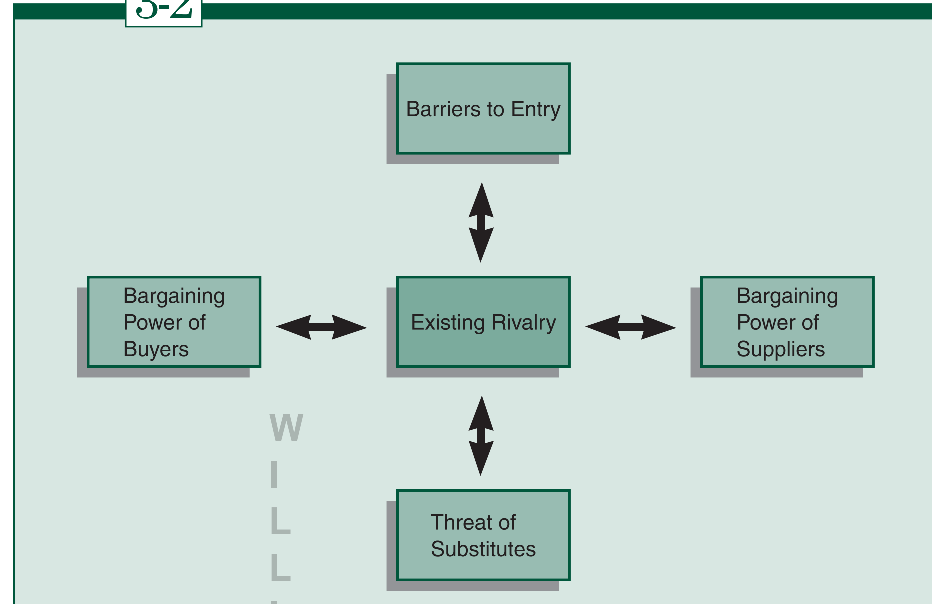


FIGURE 3-2 Porter's Five Forces Model



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These five factors combine to form the industry structure and suggest (but do not guarantee) profitability prospects for firms that operate in the industry. Each of the factors is discussed in greater detail in sections 3-3 through 3-7.

3-3 Intensity of Rivalry among Incumbent Firms

Competition intensifies when a firm identifies the opportunity to improve its position or senses competitive pressure from other businesses in its industry, which can result in price wars, advertising battles, new product introductions or modifications, and even increased customer service or warranties.[7] Rivalry can be intense in some industries. For example, a battle wages in the U.S. real-estate industry, where traditional brokers who earn a commission of 5 to 6 percent are being challenged by discount brokers who charge sellers substantially lower fees. Agents for the buyer and seller typically split commissions, which usually fall in the $7,000 range for both agents when a home sells for $250,000. Discount brokers argue that the primary service provided by the seller's agent is listing the home in a multiple listing service (MLS) database, the primary tool used by most buyers and their agents to peruse available properties. Discount brokers provide sellers with a MLS listing for a flat fee in a number of markets, sometimes less than $1,000. Traditional brokers are angry, however, and argue that discount brokers simply do not provide the full array of services available at a so-called full-service broker. Traditional brokers dominate the industry, accounting for 98 percent of all sales in 2005. They often control the local MLS databases, and many discount brokers charge that they are not provided equal access to list their properties.[8] Hence, rivalry in this industry—especially between full-service and discount brokers—remains quite intense.

Competitive intensity often evolves over time and depends on a number of interacting factors, as discussed in sections 3-3a through 3-3h. Factors should be assessed independently and then integrated into an overall perspective.

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3-3a Concentration of Competitors

The number of companies in the industry and their relative sizes or power levels influence an industry's intensity of rivalry. Industries with few firms tend to be less competitive, but those with many firms that are roughly equivalent in size and power tend to be more competitive, as each firm fights for dominance. Competition is also likely to be intense in industries with large numbers of firms because some of those companies may believe that they can make competitive moves without being noticed.[9]

3-3b High Fixed or Storage Costs

When firms have unused productive capacity, they often cut prices in an effort to increase production and move toward full capacity. The degree to which prices (and profits) can fall under such conditions is a function of the firms' cost structures. Those with high fixed costs are most likely to cut prices when excess capacity exists, because they must operate near capacity to be able to spread their overhead over more units of production.

The U.S. airline industry experiences this problem periodically, as losses generally result from planes that are flying substantially less than full or those that are not flying at all. This dynamic often results in last-minute fare specials in an effort to fill seats that would otherwise fly vacant. During the difficult times for U.S. airlines immediately following the 9/11 terrorist attacks, frequent price wars were often initiated by low-cost airlines such as JetBlue, Southwest, and AirTran.[10] Interestingly, airlines filled 73.4 percent of their seats in 2003 compared to only 63.5 percent a decade earlier.[11]

3-3c Slow Industry Growth

Firms in industries that grow slowly are more likely to be highly competitive than companies in fast growing industries. In slow-growth industries, one firm's increase in market share must come primarily at the expense of other firms'

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shares. Competitors often attend more to the actions of their rivals than to consumer tastes and trends when formulating strategies.

Slow industry growth can be caused by a sluggish economy, as was the case for vehicles during the early 2000s. As a result, manufacturers began to emphasize value by enhancing features and cutting costs. Ford, DaimlerChrysler, Nissan, Toyota, and others began to produce slightly larger trucks with additional features, while trimming prices. Producers also began to develop lower priced luxury cars in a fierce battle for sales.[12]

Slow industry growth—and even declines—are frequently caused by shifts in consumer demand patterns. For example, per capita consumption of carbonated soft drinks in the United States fell from its peak of fifty-four gallons in 1997 to approximately fifty-two gallons by 2004. During this same period, annual world growth declined from 9 percent to 4 percent as consumption of fruit juices, energy drinks, bottled water, and other noncarbonated beverages continued to rise. Coca-Cola and PepsiCo acquired or developed a number of noncarbonated brands during this time in efforts to counter the sluggish growth prospects in soft drinks. Interestingly, these rivals now appear to have modified their industry definitions from a narrow "soft drink" focus to a broader perspective including noncarbonated beverages.[13]

3-3d Lack of Differentiation or Low Switching Costs

Switching Costs
One-time costs that buyers of an industry's outputs incur as they switch from one company's products or services to another's.

The more similar the offerings among competitors, the more likely customers are to shift from one to another. As a result, such firms tend to engage in price competition. **Switching costs** are one-time costs that buyers incur when they switch from one company's products or services to another. When switching costs are low, firms are under considerable pressure to satisfy customers who can easily switch competitors at any time. When products or services are less differentiated, purchase decisions are based on price and service considerations, resulting in greater competition.

Interestingly, firms often seek to create switching costs in efforts to encourage customer loyalty. Internet Service Provider (ISP) America Online, for example, encourages users to obtain and use AOL e-mail accounts. Historically, these accounts were eliminated if the AOL customer switched to another ISP. Free e-mail accounts with Yahoo and other providers proliferated in the mid-2000s, however. As a result, AOL loosened this restriction in 2006, suggesting that most consumers no longer see the loss of an e-mail account as a major factor when considering a switch to another ISP (see Strategy at Work 3-1). Frequent flier programs also reward fliers who fly with one or a limited number of airlines. The Southwest Airlines generous program rewards only customers who complete a given number of flights within a twelve-month period, thereby effectively raising the costs of switching to another airline.

The cellular telephone industry in the United States benefited from key switching costs for a number of years. Until regulations changed in late 2003, consumers who switched providers were not able to keep their telephone numbers. Hence, many consumers were reluctant to change due to the hassle associated with alerting friends and business associates of the new number. Today, however, "number portability" greatly reduces switching costs, allowing consumers to retain their original telephone number when they switch providers.[14]

3-3e Capacity Augmented in Large Increments

When production can be easily added one increment at a time, overcapacity is not a major concern. If economies of scale or other factors dictate that

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Rivalry and Cooperation in Internet Services

Amidst a flurry of copromotion agreements between retailers and Internet brands, Microsoft and Best Buy embarked on a strategic alliance that includes Internet, broadcasting, and in-store promotional projects. Microsoft utilizes the new agreement to expand its distribution and increase subscribers to its Internet services. The agreement also displays and promotes the Best Buy logo and BestBuy.com links at Microsoft's Web sites and broadcasting properties, including the Expedia.com travel service, Microsoft's e-mail services, Hotmail, WebTV Network, the new MSN eShop online, and MSNBC. In return, Best Buy became a major advertiser with Microsoft's Internet and broadcast properties.

Wal-Mart and America Online (AOL) have also teamed up to drive traffic to Wal-Mart's Web site and introduce millions of customers to the AOL brand. AOL is most interested in the in-store promotion of its online service in more than four thousand Wal-Mart stores in the United States, in return for promoting Wal-Mart's online store to its 18 million subscribers. Under the agreement, AOL also provides Web design assistance to the nation's largest retailer.

Sources: R. Spiegel, "Microsoft and Best Buy Join Alliance Frenzy," E-Commerce Times, *16 December, 1999; C. Dembeck, "Wal-Mart Looking to AOL for E-Commerce Boost,"* E-Commerce Times, *13 December, 1999; C. Dembeck, "Yahoo! and Kmart Forge Alliance to Counter AOL,"* E-Commerce Times, *14 December 1999.*

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production be augmented in large blocks, however, then capacity additions may lead to temporary overcapacity in the industry, and firms may cut prices to clear inventories. Airlines and hotels, for example, usually must acquire additional capacity in large increments because it is not feasible to add a few airline seats or hotel rooms as demand warrants. When additional blocks of seats or rooms become available, firms are under intense pressure to cover the additional costs by filling them.

3-3f Diversity of Competitors

Companies that are diverse in their origins, cultures, and strategies often have different goals and means of competition. Such firms may have a difficult time agreeing on a set of combat rules. As such, industries with global competitors or with entrepreneurial owner-operators tend to be diverse and particularly competitive. Internet businesses often change the rules for competition by emphasizing alternative sources of revenue, different channels of distribution, or a new business model. This diversity can sharply increase rivalry.

3-3g High Strategic Stakes

Competitive rivalry is likely to be high if firms also have high stakes in achieving success in a particular industry. For instance, many strong, traditional companies cannot afford to fail in their Web-based ventures if their strategic managers believe a Web presence is necessary even if it is not profitable. These desires can often lead a firm to sacrifice profitability.

3-3h High Exit Barriers

Exit barriers are economic, strategic, or emotional factors that keep companies from leaving an industry even though they are not profitable or may even be losing money. Examples of exit barriers include fixed assets that have no alternative uses, labor agreements that cannot be renegotiated, strategic partnerships among business units within the same firm, management's unwillingness to leave an industry because of pride, and governmental pressure to continue operations

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to avoid adverse economic effects in a geographic region.[15] When substantial exit barriers exist, firms choose to compete as a "lesser of two evils," a practice that can drive down the profitability of competitors as well.

3-4 Threat of Entry

An industry's productive capacity expands when new competitors enter. Unless the market is growing rapidly, new entrants intensify the fight for market share, thus lowering prices and, ultimately, industry profitability. When large, established firms control an industry, new entrants are often pelted with retaliation when they establish their operations or begin to promote their products aggressively. For example, when Dr. Pepper launched Like Cola directly against Coke and Pepsi, an effort to make inroads into the cola segment of the soft drink market, the two major competitors responded with strong promotional campaigns to thwart the effort. If prospective entrants anticipate this kind of response, they are less likely to enter the industry in the first place. As such, entry into an industry may well be deterred if the potential entering firm expects existing competitors to respond forcefully. Retaliation may occur if incumbent firms are committed to remaining in the industry or have sufficient cash and productive capacity to meet anticipated customer demand in the future.[16]

Barriers to Entry
Obstacles to entering an industry, including economies of scale, brand identity and product differentiation, capital requirements, switching costs, access to distribution channels, cost disadvantages independent of size, and government policy.

The likelihood that new firms will enter an industry is also contingent on the extent to which **barriers to entry** have been erected—often by existing competitors—to keep out prospective newcomers.[17] From a global perspective, many barriers have declined, as firms in countries such as India and China make use of technology—and specifically a developing global fiber-optic network—to gain access to industries in the West. For example, as many as half a million IRS tax returns are prepared annually in India. Hence, barriers are always changing as technology, political influences, and business practices also change.[18]

The seven major barriers (obstacles) to entry are described in sections 3-4a through 3-4g (see also Strategy at Work 3-2). As with intensity of rivalry, they should be assessed independently and then integrated into an overall perspective on entry barriers.

3-4a Economies of Scale

Economies of scale refer to the decline in unit costs of a product or service that occurs as the absolute volume of production increases. Scale economies occur when increased production drives down costs and can result from a variety of factors, most namely high firm specialization and expertise, volume purchase discounts, and a firm's expansion into activities once performed at higher costs by suppliers or buyers. Substantial economies of scale deter new entrants by forcing them either to enter an industry at a large scale—a costly course of action that risks a strong reaction from existing firms—or to suffer substantial cost disadvantages associated with a small-scale operation. For example, a new automobile manufacturer must accept higher per-unit costs as a result of the massive investment required to establish a production facility unless a large volume of vehicles can be produced at the outset.

3-4b Brand Identity and Product Differentiation

Established firms may enjoy strong brand identification and customer loyalties that are based on *actual or perceived* product or service differences. Typically, new entrants must incur substantial marketing and other costs over an extended time to overcome this barrier. Differentiation is particularly important among products

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STRATEGY AT WORK 3-2

Creating Barriers to Entry in the Airline Industry

U.S. airline deregulation in 1978 was intended to encourage new start-up ventures and to foster competition. For a while, it seemed to be working; new companies such as Southwest Airlines and AirTran helped to lower ticket prices significantly. Over time, however, the major airlines have succeeded in erecting enormous barriers to entry, such as the following:

1. The global alliances that exist among major world carriers result in substantial control over hubs and passenger-loading gates at large airports, where such carriers already typically hold twenty- to forty-year leases. In addition, most airlines have a large number of U.S. hub airports, a feeder system to those hubs, and international routes that tie into the hubs. Such systems take decades and hundreds of millions of dollars to acquire.
2. Major airlines own the computer reservation systems, negotiate commission arrangements with travel agents for bringing business to them, and charge small carriers hefty fees for tickets sold through these systems. By operating their own Web sites, U.S. airlines have been able to eliminate the commission fees paid for domestic bookings.
3. All major carriers operate frequent flier programs that encourage passengers to avoid switching airlines. Many of the programs expire when a passenger does not fly on the airline after a specific period of time, often three years.
4. Airline computer-pricing systems enable them to selectively offer low fares on certain seats and to certain destinations (often purchased well in advance or at the last minute), thereby countering a start-up airline's pricing edge.
5. The dominant major carriers are willing to match or beat the ticket prices of smaller, niche airlines, and often respond to price changes within hours. Most are capable of absorbing some degree of losses until weaker competitors are driven out of business.

These barriers are designed to keep control of the airline industry's best routes and markets in the hands of a few carriers, even after two decades of deregulation. As such, newly formed carriers are often limited to less desirable routes. Although many upstarts fail in their first year or two of operation, others such as Southwest, AirTran, and JetBlue have been successful and are filling viable niches in the industry. Interestingly, the airline industry fallout from the events of 9/11 were felt the most by established competitors such as USAir and United Airlines.

Sources: T. A. Hemphill, "Airline Marketing Alliances and U.S. Competition Policy: Does the Consumer Benefit?" Business Horizons, *March 2000; P. A. Greenberg, "Southwest Airlines Projects $1B in Online Sales,"* E-Commerce Times, *8 December 2000; P. A. Greenberg and M. Hillebrand, "Airlines Band Together to Launch Travel Site,"* E-Commerce Times, *8 December 2000; P. A. Greenberg, "Six Major Airlines to Form B2B Exchange,"* E-Commerce Times, *8 December 2000; P. Wright, M. Kroll, and J. A. Parnell,* Strategic Management: Concepts *(Upper Saddle River, NJ: Prentice Hall, 1998); S. McCartney, "Conditions Are Ideal for Starting an Airline, and Many Are Doing It,"* Wall Street Journal, *1 April 1996, A1, A7; "Boeing 1st-Quarter Profit Off 34%,"* L.A. Times Wire Services, *30 April 1996; A. L. Velocci, Jr., "USAir Defends Aggressive Pricing,"* Aviation Week & Space Technology, *21 August 1995, 28; T. K. Smith, "Why Air Travel Doesn't Work,"* Fortune, *3 April 1995, 42–49.*

and services where the risks associated with switching to a competitive product or service are perceived to be high, such as over-the-counter drugs, insurance, and baby-care products.

3-4c Capital Requirements

Generally speaking, higher entry costs tend to restrict new competitors and ultimately increase industry profitability.[19] Large initial financial expenditures may be necessary for production, facility construction, research and development, advertising, customer credit, and inventories. Some years ago, Xerox cleverly created a capital barrier by offering to lease, not just sell, its copiers. As a result, new entrants were faced with the task of generating large sums of cash to finance the leased copiers.[20]

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3-4d Switching Costs

Switching costs are the upfront costs that buyers of one firm's products may incur if they switch to those of a competitor. If these costs are high, buyers may need to test the new product first, make modifications in existing operations to accommodate the change, or even negotiate new purchase contracts. When switching costs are low—typically the case when consumers try a new grocery store—change may not be difficult. When switching costs are high, however, customers may be reluctant to change. For example, for a number of years, Apple has had the unenviable task of convincing IBM-compatible customers not only that Apple produces a superior product, but also that switching from IBM to Apple justifies the cost and inconvenience associated with software and file incompatibility. In contrast, fast-food restaurants generally have little difficulty persuading consumers to switch from one restaurant to another at the introduction of a new product.

3-4e Access to Distribution Channels

In some industries, entering existing distribution channels requires a new firm to entice distributors through price breaks, cooperative advertising allowances, or sales promotions. Existing competitors may have distribution channel ties based on long-standing or even exclusive relationships, requiring the new entrant to create its own channels of distribution. For example, certain manufacturers and retailers have formed partnerships with FedEx or UPS to transport merchandise directly to their customers. As a distribution channel, the Internet may offer an alternative to companies unable to penetrate the existing channels.

3-4f Cost Advantages Independent of Size

Many firms enjoy cost advantages emanating from economies of scale. Existing competitors may have also developed cost advantages not related to firm size, however, that cannot be easily duplicated by newcomers. Such factors include patents or proprietary technology, favorable locations, superior human resources, and experience in the industry. For example, eBay's experience, reputation, and technological capability in online auctions have made it difficult for prospective firms to enter the industry. When such advantages exist for one or more existing competitors, prospective new entrants are usually hesitant to join the industry.

3-4g Government Policy

Governments often control entry to certain industries with licensing requirements or other regulations. For example, establishing a hospital, a nuclear power facility, or an airline cannot be done in most nations without meeting substantial regulatory requirements. Although firms generally oppose government attempts to regulate their activity, this is not always the case. Existing competitors often lobby legislators to enact policies that make entry into their industry a complicated or costly endeavor.

3-5 Pressure from Substitute Products

Substitute Products
Alternative offerings produced by firms in another industry that satisfy similar consumer needs.

Firms in one industry may be competing with firms in other industries that produce **substitute products,** offerings produced by firms in another industry that satisfy similar consumer needs but differ in specific characteristics. Note that products and services affected by a firm's competitors (i.e., companies in the same industry) do *not* represent substitutes for that firm. By definition, substitutes emanate from outside of a firm's industry.

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Although they emanate from outside the industry, substitutes can limit the prices that firms can charge. For instance, low fares offered by airlines can place a ceiling on the long-distance bus fares that Greyhound can charge for similar routes. Hence, firms that operate in industries with few or no substitutes are more likely to be profitable.

3-6 Bargaining Power of Buyers

The buyers of an industry's outputs can lower that industry's profitability by bargaining for higher quality or more services and playing one firm against another. Levi Strauss discovered this when negotiating a sizeable contract with mega-retailer Wal-Mart. The famous American jean-maker was forced to create a lower cost brand by overhauling production and distribution efforts.[21]

The following circumstances can raise the bargaining power of an industry's buyers.

1. Buyers are concentrated, or each one purchases a significant percentage of total industry sales. If a few buyers purchase a substantial proportion of an industry's sales, then they will wield considerable power over prices. This is especially prevalent in markets for components and raw materials.
2. The products that the buyers purchase represent a significant percentage of the buyers' costs. When this occurs, price will become more critical for buyers, who will shop for a favorable price and will purchase more selectively.
3. The products that the buyers purchase are standard or undifferentiated. In such cases, buyers are able to play one seller against another and initiate price wars.
4. Buyers face few switching costs and can freely change suppliers.
5. Buyers earn low profits, creating pressure for them to reduce their purchasing costs.
6. Buyers have the ability to engage in backward integration by becoming their own suppliers. Large automobile manufacturers, for example, use the threat of self-manufacture as a powerful bargaining lever.
7. The industry's product is relatively unimportant to the quality of the buyers' products or services. In contrast, when the quality of the buyers' products is greatly affected by what they purchase from the industry, the buyers are less likely to have significant power over the suppliers because quality and special features will be the most important characteristics.
8. Buyers have complete information. The more information buyers have regarding demand, actual market prices, and supplier costs, the greater their bargaining power. The advent of the Internet has increased the quantity and quality of information available to buyers in a number of industries.

3-7 Bargaining Power of Suppliers

The tug of war between an industry's rivals and their suppliers is similar to that between the rivals and their buyers. When suppliers to an industry wield collective power over the firms in the industry, they can siphon away a portion of excess profits that may be gleaned. Alternatively, when an industry's suppliers are weak, they may be expected frequently to cut prices, increase quality, and add services. This was the case among U.S. automakers during the 1990s and early 2000s. Marred by mounting financial losses, Detroit's "Big Three" producers constantly squeezed their suppliers for price concessions. By the mid to late 2000s, however, many of these suppliers found themselves in Chapter 11 bankruptcy while others had developed a profitable nonauto business. Hence, power shifted from the automakers in favor of the suppliers during this time, an unwelcome reality to struggling GM, Ford, and Chrysler.[22]

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The struggle between U.S. service stations and their suppliers—big oil companies—is another interesting example. When the popularity of E85 ethanol—a mixture containing 85 percent ethanol and 15 percent gasoline—began to rise in the mid to late 2000s, many U.S. service stations were prohibited from carrying the alternative fuel. Oil companies that do not supply E85 lose sales every time a driver fills the tank with the ethanol mix. As a result, many prohibit their franchisees from carrying fuel from other producers. Service stations that are allowed to carry E85 are often required to dispense it from a pump on a separate island not under the main canopy—a costly endeavor. Because there are only a few major oil companies and thousands of service stations in the United States, the oil companies are able to wield most of the power.[23]

The conditions that make suppliers powerful are similar to those that affect buyers. Specifically, suppliers are powerful under the following circumstances.

1. The supplying industry is dominated by one or a few companies. Concentrated suppliers typically exert considerable control over prices, quality, and selling terms when selling to fragmented buyers.
2. There are no substitute products, weakening buyers in relation to their suppliers.
3. The buying industry is not a major customer of the suppliers. If a particular industry does not represent a significant percentage of the suppliers' sales, then the suppliers control the balance of power. If competitors in the industry comprise an important customer, however, suppliers tend to understand the interrelationships and are likely to consider the long-term viability of their counterparts—not just price—when making strategic decisions.
4. The suppliers pose a credible threat of forward integration by "becoming their own customers." If suppliers have the ability and resources to operate their own manufacturing facilities, distribution channels, or retail outlets, then they will possess considerable control over buyers.
5. The suppliers' products are differentiated or have built-in switching costs, thereby reducing the buyers' ability to play one supplier against another.

3-8 Limitations of Porter's Five Forces Model

Generally speaking, the five forces model is based on the assumptions of the industrial organization (IO) perspective on strategy, as opposed to the resource-based perspective. Although the model serves as a useful analytical tool, it has several key limitations. First, it assumes the existence of a clear, recognizable industry. As complexity associated with industry definition increases, the ability to draw coherent conclusions from the model diminishes. Likewise, the model addresses only the behavior of firms in an industry and does not account for the role of partnerships, a growing phenomenon in many industries. When firms work together, either overtly or covertly, they create complex relationships that are not easily incorporated into industry models.

Second, the model does not consider that some firms, most notably large ones, can often take steps to modify the industry structure, thereby increasing their prospects for profits. For example, large airlines have been known to lobby for hefty safety restrictions to create an entry barrier to potential upstarts. Mega-retailer Wal-Mart even employs its own team of lobbyists on Capitol Hill.

Third, the model assumes that industry factors, not firm resources, comprise the primary determinants of firm profit. This issue continues to be

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widely debated among both scholars and executives.[24] This limitation reflects the ongoing debate between IO theorists who emphasize Porter's model and resource-based theorists who emphasize firm-specific characteristics. The resource-based perspective is addressed later in the strategic management process.

Finally, a firm that competes in many countries typically must analyze and be concerned with multiple industry structures. The nature of industry competition in the international arena differs among nations, and may present challenges that are not present in a firm's host country.[25] One's definition of McDonald's industry may be limited to fast-food outlets in the United States, but may also include a host of sit-down restaurants when other countries are considered. Different industry definitions for a firm across borders can make the task of assessing industry structure quite complex.

These challenges notwithstanding, a thorough analysis of the industry via the five forces model is a critical first step in developing an understanding of competitive behavior within an industry.[26] In a general sense, Porter's five forces model provides insight into profit-seeking opportunities, as well as potential challenges, within an industry (see Case Analysis 3-2).

Case Analysis 3-2

Step 3: Potential Profitability of the Industry

Porter's five forces model should be applied to the industry environment, as identified in step 2, by examining threat of entry, rivalry among existing competitors, pressure from substitute products, and the bargaining power of buyers and suppliers. Each of the specific factors identified in the rivalry and new entrants sections (3-3 and 3-4) should be assessed individually. In addition, each of the five forces should be evaluated with regard to its positive, negative, or neutral effect on potential profitability in the industry. It is also useful to provide an overall assessment (considering the composite effect of all five forces) of potential profitability that identifies the industry as either profitable, unprofitable, or somewhere in between.

Step 4: Who Has Succeeded and Failed in the Industry, and Why? What Are the Critical Success Factors?

Every industry has recent winners and losers. To understand the **critical success factors (CSFs)**–factors that tend to be essential for success for most or all competitors within a given industry—one must identify the companies that are doing well and those that are doing poorly, and determine whether their performance levels appear to be associated with similar factors. For example, McDonald's, Burger King, and Taco Bell are successful players in the fast-food industry. In contrast, Rax and Hardee's have been noted for their subpar performance. Are any common factors partially responsible for the differences in performance? Consider that many analysts have noted that consistency and speed of service are critical success factors in the fast-food industry. Indeed, McDonald's, Burger King, and Taco Bell are all noted for their fast, consistent service, whereas Rax and Hardee's have struggled in this area.

A business may succeed even if it does not possess a key industry CSF; however, the *likelihood* of success is diminished greatly. Hence, strategies that do not shore up weaknesses in CSF areas should be considered carefully before being implemented.

Critical Success Factors (CSFs)
Factors that are generally prerequisites for success among most or all competitors in a given industry.

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3-9 Summary

An industry is a group of companies that produce similar products or services. Michael Porter has identified five basic competitive industry forces that can ultimately influence profitability at the firm level: intensity of rivalry among incumbent firms in the industry, the threat of new entrants in the industry, the threat of substitute products or services, bargaining power of buyers of the industry's outputs, and bargaining power of suppliers to the industry. Firms tend to operate quite profitably in industries with high entry barriers, low intensity of competition among member firms, no substitute products, weak buyers, and weak suppliers. These relationships are tendencies, however, and do not mean that all firms will perform in a similar manner because of industry factors. Although Porter's model has its shortcomings, it represents an excellent starting point for positioning a business among its competitors.

Key Terms

barriers to entry
critical success factors
exit barriers
industry
industry life cycle
market share
relative market share
substitute products
switching costs

Review Questions and Exercises

1. Visit the Web sites of several major restaurant chains. Identify the industry(s) in which each one operates. Would you categorize them in the same industry or in different industries (fast food, family restaurants, etc.)? Why or why not?
2. Identify an industry that has low barriers to entry and one that has high barriers. Explain how the difference in entry barriers influences competitive behavior in the two industries.
3. Identify some businesses whose sales have been adversely affected by substitute products. Why has this occurred?
4. Identify an industry in which the suppliers have strong bargaining power and another industry in which the buyers have most of the bargaining power. How does this affect potential profitability in both industries?

Practice Quiz

True or False

1. Each firm operates in a single, distinct industry.
2. All industries follow the stages of the industry life cycle model.
3. The likelihood that new firms will enter an industry is contingent on the extent to which barriers to entry have been erected.
4. Higher capital requirements for entering an industry ultimately raise average profitability within that industry.
5. Substitute products are produced by competitors in the same industry.
6. A key limitation of Porter's five forces model is its reliance on resource-based theory.

Multiple Choice

7. Industry growth is no longer rapid enough to support a large number of competitors in which stage of industry growth?
   - **A.** growth
   - **B.** shakeout
   - **C.** maturity
   - **D.** decline

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8. The intensity of rivalry among firms in an industry is dependent on which of the following?

A. concentration of competitors

B. high fixed or storage costs

C. high exit barriers

D. all of the above

9. The decline in unit costs of a product or service that occurs as the absolute volume of production increases is known as

A. production effectiveness.

B. effective operations management.

C. economies of scale.

D. technological analysis.

10. When switching costs are high,

A. customers are less likely to try a new competitor.

B. companies spend more on technology.

C. companies seek new suppliers to reduce costs.

D. none of the above

11. Which of the following is not a cost advantage independent of scale?

A. proprietary technology

B. favorable locations

C. experience in the industry

D. high volume of production

12. What is occurring when those who purchase an industry's goods and services exercise great control over pricing and other terms?

A. high bargaining power of suppliers

B. low bargaining power of suppliers

C. balance of power among suppliers

D. none of the above

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READING 3-1

Insight from *strategy+business*

The airline industry has undergone remarkable changes during the past two decades, particularly after the 9/11 terrorist attacks. In this chapter's strategy+business reading, Hansson and associates challenge the wisdom of the business models employed by traditional airlines. They argue that the structure of the industry has changed and that astute airlines will tailor their approaches to the new reality.

Flight for Survival

A New Business Model for the Airline Industry

To pare down their colossal operating costs, giant U.S. and European carriers must restructure the hub-and-spoke system and eliminate complexity.

By Tom Hansson, Jürgen Ringbeck, and Markus Franke

Since the 1970s, traditional market leaders in industry after industry, saddled with complex, high-cost business models, have been under attack by companies with new, simpler ways to manage their operations and contain costs.[1]

This scenario occurred in the steel industry when minimills took on traditional smelters; in automobile manufacturing when more standardized Japanese cars won out over customized U.S. vehicles; and in retailing when superstores overtook conventional grocery stores. In each instance, the established companies struggled, often in vain, to rationalize operations and still deliver products and services to satisfy customer desires, defend their market positions, and reestablish profitability.

The lesson is fundamental: As markets mature, incumbent companies that have developed sophisticated, but complex, business models face tremendous pressure to find less costly approaches that meet broad customer needs with minimal complexity in products and processes.

The trouble is, many companies — manufacturers and service providers alike — have increased the scope and variety of their products and services over the years by layering on new offerings to serve ever larger and more diverse customer bases. Although each individual business decision to enhance a product line or service can usually be justified on its own, the result often is a cost structure that is sustainable only if the principal competitors take a similar approach. More often than not, though, as incumbents expand the breadth and depth of their offerings, leveraging their sophisticated business infrastructure, they are undermined by smaller, nimbler competitors that supply a more focused product, usually to a specific set of customers, at a substantially lower cost. In these situations, the incumbent may know that the cost of complexity is dragging it down, but finds changing its business model easier said than done.

No companies illustrate this dilemma more vividly than the large U.S. and European hub-and-spoke airlines. Their business model — essentially designed to seamlessly take anyone from anywhere to everywhere — was a great innovation. But this model is no longer competitively sustainable in its current form. Tied to massive physical infrastructure, complex fleets of aircraft, legacy information systems, and large labor pools, the major carriers in both regions now face a double whammy: some of the worst economic conditions in the industry's history, and low-cost carriers that dictate prices in large and growing parts of the market.

U.S. carriers lost more than $10 billion in 2002, according to the Air Transport Association, up from $8 billion in the disastrous year of 2001. Worldwide, losses topped $50 billion. Bankruptcies litter the industry. Sabena, Swissair, US Airways, United Air Lines, and Hawaiian Airlines have all sought protection from their creditors. Others are likely to follow. The need for a new, less complex business model among hub-and-spoke carriers is growing stronger with each boom and bust cycle.

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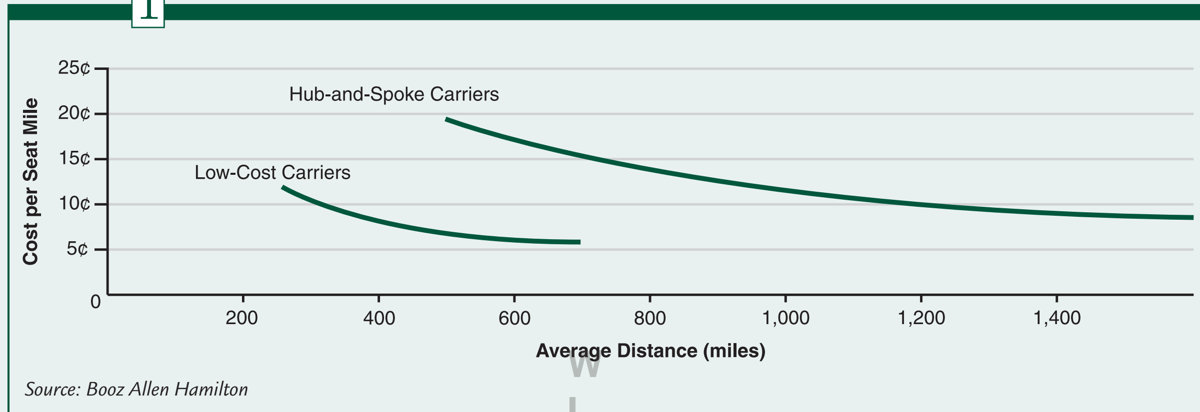
EXHIBIT 1 Average Cost per Seat Mile (in 2000)



Source: Booz Allen Hamilton

In this article, we examine the significant downside of business complexity and provide a formula that would allow the airlines to simplify their operations, cut expenses, and compete with their low-cost competitors. It's not incremental change, but a fundamental overhaul.

Complexity Costs

While the major carriers face a future of red ink, low-cost carriers such as Southwest Airlines, JetBlue Airways, and Ryanair are prospering by exploiting a huge cost-of-operations advantage. Low-cost carriers spend seven to eight cents per seat mile to complete a 500- to 600-mile flight, according to our analysis. That's less than half of what it costs the typical hub-and-spoke carrier to fly a flight of the same duration and distance. (See Exhibit 1.)

It is easy to see how costs mount quickly in the hub-and-spoke airlines' intricate system of operations. Their business model is predicated on offering consumers a larger number of destinations, significant flexibility (ranging from last-minute seat reassignments and upgrades to complete itinerary and routing changes), and "frills" (e.g., specialty meals, private lounges, and in-flight entertainment). It is a model burdened by the built-in cost penalties of synchronized hub operations, with long aircraft turnaround times and slack built into schedules to increase connectivity by ensuring there is time for passengers and baggage to make connections. It's a system that implicitly accepts a slower business pace to accommodate continual change. In addition, the hub-and-spoke business model relies on highly sophisticated information systems and infrastructure to optimize its complex operations. By contrast, low-cost carriers have designed a focused, simple, highly productive business model around nonstop air travel to and from medium- to high-density markets at a significantly lower price point.

We have analyzed the cost gap between large full-service airlines and low-cost carriers (LCCs) on both sides of the Atlantic, and the similarities are striking. On both continents, cost differences exist across the board; pilots, onboard services, sales and reservations, maintenance, aircraft ownership, ground handling. The low-cost carriers are not simply paying lower salaries or using cheaper airports, they are leveraging all resources much more effectively. In fact, the cost differential between the full-service and low-cost carriers is 2 to 1 for the same stage length and aircraft, even after adjustments for differences in pay scales, fuel prices, and seat density are made.

Surprisingly, only about 5 percent of this cost differential can be attributed to the extra amenities the hub-and-spoke carriers offer. Some 65 percent of the LCCs' cost advantage is the result of other production-model choices; another 15 percent comes from work rules and labor agreements; and 12 percent can be attributed to differences in balance-sheet structure and financial arrangements. (See Exhibit 2.)

Of the costs attributable to production-model differences, the largest contributing factors are business pace, process complexity, and ticket distribution. In fact, "no frills" and "full service" are misleading labels to describe the distinction between the two types of carriers. It is the relative simplicity or complexity of their operations that truly distinguishes them.

Most debilitating for the major carriers is the inability to overcome their cost burden with boom period pricing, as they did in the second half of the 1990s. As corporations tightened their belts and reduced the frequency of travel, business travelers, who have traditionally accounted for

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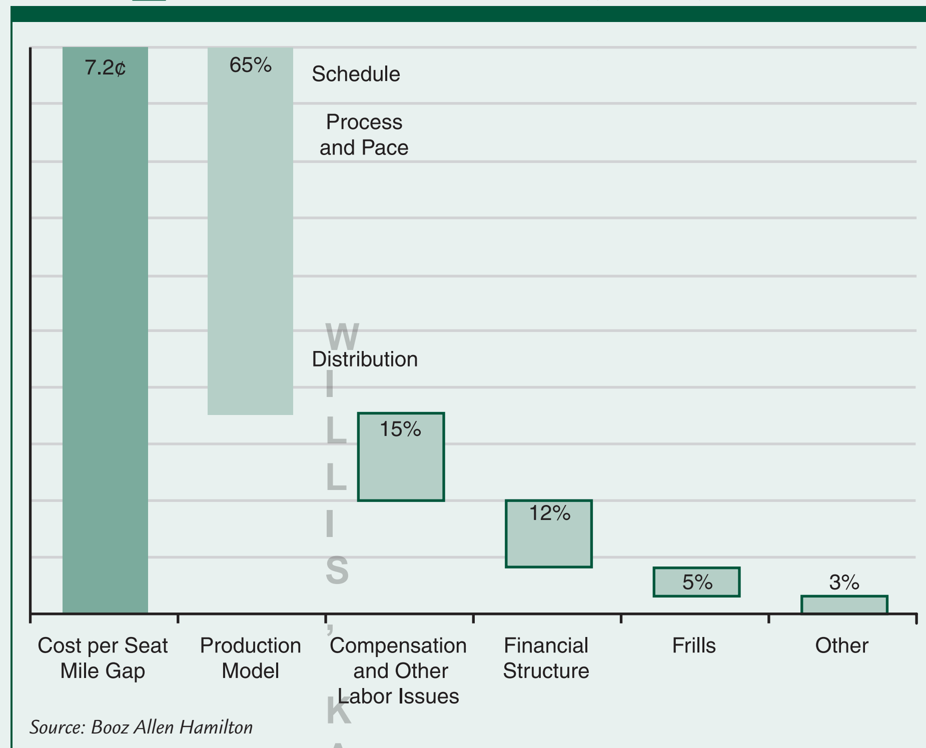
EXHIBIT 2 Breakout of the Cost per Seat Mile Gap Between Full-Service and Low-Cost Carriers (in 2000)



Source: Booz Allen Hamilton

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as much as 60 percent of mainline airline revenues – and well over 100 percent of their profits – were no longer willing to pay the high fares they tolerated in the dot-com boom. Weakened by this fundamental change in customer choice as well as "industry leading" labor agreements and rising fuel prices, the U.S. hub-and-spoke airlines' cost per seat mile (CASM) rose above revenue per seat mile (RASM) by the third quarter 2000, a full year before the September 11 terrorist attack slashed air travel further. This eventually increased to an unprecedented cost-to-revenue gap of close to 2 cents per seat mile at the beginning of 2002 in the U.S.

That revenue outlook is likely to get worse. By our conservative estimates, low-cost carriers could potentially—and successfully – participate in more than 70 percent of the U.S. domestic market. Southwest Airlines typically prices 50 percent lower than large carriers in one- to two-hour nonstop markets. Even though traditional airlines have attracted a richer business mix than the low-cost carriers, they still stand to lose 25 to 35 percent price realization in those markets.

Recently, huh-and-spoke airlines have been trying to lower operating costs through new, less onerous labor agreements – American Airlines, United Air Lines, and US Airways have led the way in eking out pay concessions from their employees; negotiating better deals with intermediaries and financiers; eliminating discretionary costs; and, in some cases, smoothing out hub operations. Major carriers in the U.S. and Europe have also announced that they will add low-cost airline subsidiaries to their business portfolios to compete with the likes of Ryanair and Southwest Airlines.

A New Path

Many of these restructuring initiatives are clearly valuable and necessary, but they will likely not prove to be enough. Core airline operations need to become competitive with those of low-cost carriers, especially as LCC market penetration grows in the U.S. and makes inroads in Europe. The steps large carriers have taken so far do not address the fundamental productivity differences between themselves and the low-cost airlines. Traditional

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airlines will not achieve a competitive cost structure if they do not tackle the fundamental cost penalties associated with their business models. But they must do so without compromising the services, service quality, and coverage that distinguish them from their new rivals.

Although making such fundamental changes in a long-standing business model is difficult and risky, it is not without precedent. Successful change in other industries—such as manufacturing and financial services—provides important insights into the ways the burden and cost of complexity can be reduced. Not long ago, a major U.S.-based manufacturer of a highly engineered product realized that its policy of allowing extensive customization was increasing operating cost without delivering commensurate revenue benefits. Certain elements of this company's products required customization, but by a natural progression of complexity, customization had become an unintentional—and unnecessary—centerpiece of the manufacturing process. Inventory, scheduling, delivery logistics, and the like were built around the ability to alter specifications quickly. The company's operational resources directed toward the most complicated features of manufacturing, rather than the simplest. And that was introducing significantly higher costs into its business model.

The manufacturer did an exhaustive study and found, to its surprise, that about 70 percent of the features in its products were never customized. The company introduced engineering controls to these less complicated aspects of the manufacturing process. By taking that step, the manufacturer was able to strategically apply complex systems–such as manufacturing resource planning, inventory, and expediting programs–to only the 30 percent of the design and plant processes that required customization. These segmented operations are called tailored business streams (TBS). Because of this action, which did not hamper service for those customers needing customization, the company is on course to slash 15 percent from its operational expense.

Large carriers must seriously consider three critical elements when restructuring the hub-and-spoke model and eliminating complexity from their business model.

- **Remove Scheduling Constraints.** At present, hub-and-spoke airlines generally schedule flights in a so-called wave system, which means that departures and arrivals are concentrated in peak periods to maximize effective passenger connections. However, the approach causes long aircraft turnarounds (to allow passengers and baggage to connect to their next flight), traffic congestion, and aircraft downtime at the origin cities, resulting in low labor and aircraft utilization. This system, which is structured around the needs of the least profitable connecting passengers, also necessitates more complicated logistics and provides significantly lower yields–up to 45 percent less revenue per mile than for passengers traveling nonstop. Nevertheless, because of current pricing strategies and fleet structures, airlines rely on connecting passengers to fill seats that otherwise would be empty.

By redesigning the airline's network around the needs of nonstop passengers, and making connections a byproduct of the system as Southwest Airlines does, large carriers should be able to cut turnaround times by as much as half, increase aircraft utilization, reduce congestion, and significantly improve labor productivity. A large portion of manpower costs is driven by how long an aircraft is at the gate. Shorter turns would mean that pilots, flight attendants, baggage handlers, maintenance staff, and other personnel could be much more productive, and still in compliance with safety regulations. Moreover, with aircraft ready to take off more quickly, airlines could schedule more flights and provide more attractive timetables for nonstop passengers.

The trade-off between efficient operations and connectivity has to be evaluated carefully, however. Most likely the solution will involve "continuous" or "rolling" hubs, which would allow for more operationally efficient, continuous flight schedules throughout the day. The approach would be particularly suited for "mega-hubs," where the local "point-to-point" market is sufficiently large to support more frequent flights without relying as much on connecting traffic. Some airlines are already experimenting with rolling hubs. To fully realize the cost reduction opportunities created by this approach, and to justify the scheduling change, airlines will need to fundamentally alter airport operations, through such innovations as compressed turns and simplified baggage handling.

- **Implement Tailored Business Streams.** In other industries, such as manufacturing, complexity reduction has been achieved by applying a TBS approach. The basic principle is to segment operations into distinct business streams: Separate processes are created to handle routine and complex activities; capabilities and approaches are tailored to the inherent complexity of the chosen task and based on what customers are willing to pay. That often entails standardizing or "industrializing" the routine and stable processes, while segmenting and isolating the parts of the operation that are more complicated and variable.

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By and large, the hub-and-spoke airlines have done exactly the opposite. Airlines have sophisticated, universally applicable processes for handling most, if not all, possible situations. It doesn't matter whether the passenger is on a simple one-hour flight or is traveling from one continent to another. This has added unnecessary costs to processes, and made them hard to automate and change, requiring massive retraining of personnel when a process is altered. If the airlines embraced TBS, simplified their policies, and streamlined their core processes to address the basic needs of the majority of customers, they could drastically reduce the number of activities performed at airports. Furthermore, they could automate many more of them, saving huge amounts of time and money. In this environment, the reservation and passenger-handling process would be designed so that passengers wouldn't need last-minute changes or long, multiple interactions with airline staff at the airport. Instead, travelers would be able to get to the gates faster.

At airports, dedicated processing staff would still deal with the small percentage of travelers who need to change itineraries, connect to a different airline, or request other special services. And customers who require extras (except for perhaps the most frequent flyers) would potentially pay for them in the ticket price or through a transaction fee. Efficiency improvements would be systemwide, cascading from reservations to front-line staff Overall, the product and experience would be better, and the organization would be much more efficient at delivering it.

- **Create Separate Business Systems for Distinct Customer Segments.** In simplifying their business model, large carriers have to be careful to retain the loyalty of their most profitable and frequent customers by providing more differentiated amenities, lounges, and services on the ground and in the air than they do today. This could mean separating both airport and onboard services into two (or more) classes, focused on either leisure or business passengers. Other industries' experiences suggest that mingling complex and simple operations, each of which has distinct objectives and missions, often increases costs and lowers service standards. This must be avoided: The goal is to offer a higher service level where it is needed, at a low operating cost. Besides providing more amenities, this approach would help create purer business streams that reflect the distinct needs of different customer segments.

It will be important for large carriers to retain the key service advantages they have over low-cost carriers, including destination breadth, superior loyalty programs, and select onboard amenities. At a minimum, this approach would enable greater product distinction than there is today. The objective is twofold: Change the business model to serve *all* customers better by providing a more efficient and less time-consuming experience; and provide dedicated services (and flexibility) to the customer segments prepared to pay for them.

These proposed restructuring elements are highly interdependent. If they're effectively coordinated, they will increase the pace of airline operations, reduce and isolate complexity, and increase service specialization—all results that are necessary for carriers to fly beyond the industry turbulence they're experiencing today. We estimate that by adopting these approaches, the major airlines would bring costs more in line with those of low-cost carriers, reducing their unit cost disadvantage for leisure travel by 70 to 80 percent.

It won't be easy to achieve. Any industry that undertakes such change faces the fear that not only will revenue premiums be lost, but costs will not fall commensurately. It is difficult to reduce fixed-cost structures. Existing infrastructure may be underutilized with the new business model, and the current aircraft base may not fit the new requirements. Another key challenge for airlines would be the potential drop in revenue in connecting markets. But they could make up this loss by using their lower cost base to stimulate market growth, and by offering viable new services that are not economically feasible at current cost levels.

The Horizon

To survive, major airlines have no choice but to change course. With a fundamentally lower cost structure, the large airlines would be far better positioned to become profitable, grow, and launch a marketplace offensive against low-cost carriers.

At this point, the outlook for the industry is highly uncertain. If the hub-and-spoke carriers stick to the current business model, and attempt to reduce costs within today's operational framework, they risk facing continued market share loss to LCCs, a round robin of bankruptcies, and a struggle for survival. The large U.S. airlines' early 1990s crisis was a cyclical, economy-based downturn. LCCs were not a major issue then. When the economy and their performance improved, the airlines largely ignored the threat posed by the lower-cost format. That inaction only hid the real emerging problem.

This time the crisis is again cyclical, but it is exacerbated by the presence of low-cost carriers. If the economic picture brightens significantly, it's possible that the large

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airlines will rebound, and that the fundamental business model problems will not be addressed. If that happens, the next cyclical crisis will be so much worse. In the U.S., the low-cost carriers could then dictate pricing in more than 70 percent of the domestic market, as opposed to the current 40 to 45 percent. At that point, a turnaround would be significantly more challenging than it is today.

Alternatively, if a few large carriers adopt the new business model that we suggest, the industry could be led by a couple of thriving carriers in the U.S. and Europe, with one to two random hubs each serving intercontinental and small community markets, a more differentiated service offering, and a number of centers of mass similar to those operated by Southwest Airlines.

The risk of inaction is much greater than the risk of change. The first traditional airline to apply a fundamentally new business model will reshape the industry's competitive landscape. The first prize that awaits the boldest flyers is significant, not just in terms of cost reduction, but also in considerable growth and future market leadership opportunities.

Resources

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External Environment

4

Chapter Outline

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4-3 Economic Forces
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Review Questions and Exercises
Practice Quiz
Notes
Reading 4-1

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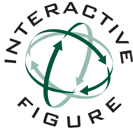
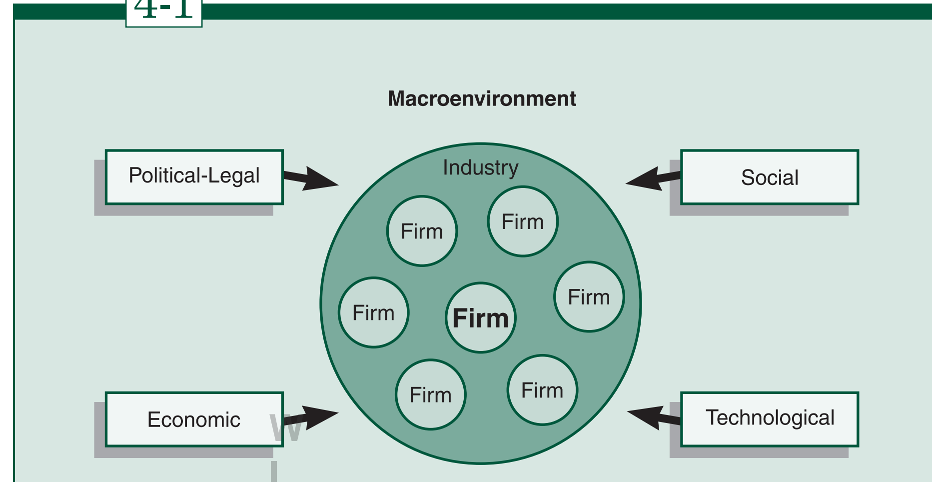


FIGURE 4-1 Macroenvironmental Forces



Macroenvironment
The general environment that affects all business firms in an industry and includes political-legal, economic, social, and technological forces.

PEST
An acronym referring to the analysis of the four macroenvironmental forces: Political-legal, Economic, Social, and Technological.

After the industry has been clearly defined and its prospects for profits identified, forces outside the industry should be considered. Constant changes in these forces present numerous opportunities and challenges to strategic managers. Hence, it is important to understand how these forces collectively influence the industry.

Every organization exists within a complex network of external forces. Together, these elements comprise the organization's **macroenvironment**. The four categories of macroenvironmental forces are political-legal, economic, social, and technological (see Figure 4-1). The analysis of macroenvironmental factors may be referenced as **PEST**, an acronym derived from the first letter of each of the four categories of forces. The effects of macroenvironmental forces on a firm's industry should be well understood before strategic options are evaluated.

4-1 Analysis of the Macroenvironment

Each macroenvironmental force embodies a number of key issues that vary across industries. Some issues are specific to a single force whereas others are related to more than one force. Automobile safety, for example, has political-legal (e.g., legislation requiring that safety standards be met), social (e.g., consumer demands for safe vehicles), and technological (e.g., innovations that may improve safety) dimensions. In such situations, one needs to understand how the various macroenvironmental forces combine to influence industry behavior and performance.

Firms operating in multiple markets may be affected in different manners by macroenvironmental forces in each market. For example, wide roads and relatively modest fuel taxes (i.e., political-legal factors), a culture that reinforces the automobile as a means of personal expression (i.e., a sociocultural factor), and a high standard of living (i.e., an economic factor) suggest higher demand for moderate to large vehicles in the United States. In contrast, narrow roads, higher fuel taxes, a view that a vehicle is more about transportation than about personal expression, and less disposable income suggest higher demand for smaller cars in Latin American countries. Hence, the application of Porter's model to firms operating in many different industry structures within a single nation or, most notably, many different nations can be quite cumbersome.

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Although large organizations and trade associations often attempt to influence change in the macroenvironment, these forces are usually not under the direct control of business organizations. On occasion, a large, dominant firm such as Wal-Mart may be able to exert some degree of influence over one or more aspects of the macroenvironment. For example, the giant retailer's political action committee contributed about $1 million to candidates and parties in the United States in both 2003 and 2004.[1] However, this level of influence is not common because strategic managers typically seek to enable a firm to operate effectively within largely uncontrollable environmental constraints while capitalizing on the opportunities provided by its environment.

The key distinction here is strategic managers must first identify and analyze these national and global macroenvironmental forces and understand how each force affects the *industries* in which they operate before addressing firm-specific strategy concerns. Hence, understanding a force's broad effects should precede understanding its specific effects. Applications of these forces that are unique or specific to the firm are considered as opportunities and threats later in the strategic management process.

4-2 Political-Legal Forces

Political-legal forces include such factors as the outcomes of elections, legislation, and judicial court decisions, as well as the decisions rendered by various commissions and agencies at every level of government. Some regulations affect many or all organizations. When the Massachusetts state legislature passed a bill in 2006 to require that businesses provide health insurance for its workers, all firms operating in the state were affected.[2] When the U.S. Supreme Court ruled in 2007 that the Clean Air Act applies to car and truck carbon dioxide emissions, carmakers knew immediately that higher federal fuel economy standards were likely forthcoming.[3]

Industries are often affected by legislation and other political events specific to their line of business, however. Consider the following examples. The U.S. Highway Traffic Safety Administration constantly tests cars and trucks sold in the United States and pressures carmakers to improve safety performance.[4] Fuel economy standards can require that producers develop new vehicles or modify existing ones to meet average fuel economy targets, which can be a costly venture. When the Bush administration proposed higher minimum standards for fuel economy, analysts estimated that the industry would spend more than $6 billion to comply, adding $275 to the price tag of a large truck by 2011.[5]

Military conflicts can also influence how certain industries operate, especially those with tight global ties. For example, during the 2003 war in Iraq, many firms modified their promotional strategies, fearing that their television advertisements might be considered insensitive if aired alongside breaking coverage of the war. At the same time, others began to plan for meeting the anticipated future needs in Iraq for such products as cell phones, refrigerators, and automobiles. After the previous Iraqi regime was ousted in mid-2003, U.S. firms began to compete vigorously for lucrative reconstruction contracts.[6]

It is not safe to assume that firms always seek less regulation. In some instances, firm leaders prefer to operate within clear boundaries established by governments. In 2004, for example, Ford chief Bill Ford said he would support higher fuel taxes in exchange for incentives to produce more energy-efficient vehicles.[7] In another example, following the sharp declines in air travel in the United States, airlines on the verge of bankruptcy campaigned for and received $15 billion in government support in 2002 and an additional $2.9 billion in 2003.[8]

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In more cases than not, however, regulation can prove costly for firms in an industry. When mad-cow disease—a rare disease of the brain passed through tainted meat—began to show up in the United Kingdom in early 2001, most of Europe responded by banning the import of British beef. Financial losses for the industry were staggering.[9] Beginning in 2005, U.S. packaged food manufacturers were required to disclose the amount of trans fats in the products they distribute through grocery stores.[10] As health advocates renewed attempts in that same year to secure governmental regulation, the U.S. food industry continued its long struggle to cut back on the use of salt. Critics warn of the link between salt and high blood pressure. Deeply ingrained in the food production process, however, salt is all but impossible to eliminate because of its many benefits. Salt is inexpensive, enhances the taste of myriad foods, and extends the shelf life of many foods.[11]

While most agree that regulations are necessary in many instances, they can be cumbersome. In 2006, the U.S. Food and Drug Administration (FDA) issued guidelines concerning when food companies can reference their products as "whole grain." Food companies can use the label if their products are made of rye, oats, popcorn, and wild rice, but not soybeans, chickpeas, and pearled barley. Use of terms such as "good source" and "excellent source" to describe the amount of whole grains included in a product are also subject to debate and FDA rulings.[12]

All societies have laws and regulations that affect business operations. A major shift in U.S. policy occurred in the late 1970s and the 1980s in favor of *deregulation,* eliminating a number of legal constraints in such industries as airlines, trucking, and banking; however, not all industries were deregulated. By 1990, a reversal of trade protectionism and strong governmental influence in business operations began to take place. In the United States, new economic policies reduced governmental influence in business operations by deregulating certain industries, lowering corporate taxes, and relaxing rules against mergers and acquisitions. This trend has continued into the twenty-first century, although not as forcefully as in the late 1990s. Table 4-1 summarizes some of the major laws in the United States.

Many broad regulations such as those listed in Table 4-1 affect multiple industries. Other regulations, however, are designed specifically for a single industry or category of firms. In 2005, for example, eighteen U.S. states implemented the Streamlined Sales Tax Project in an effort to remove obstacles preventing retailers from collecting sales taxes with online sales. Estimated potential taxes associated with Internet sales was more than $15 billion across the United States in 2003 and was expected to surpass $20 billion in 2008.[13]

Consider a second example. In 2006, a U.S. federal court ruled that cigarette manufacturers cannot use the adjectives "light" or "low tar" to describe their products. This ruling requires firms not only to rename some of their products, but also to reposition them and hope that smokers do not assume that other aspects of the cigarettes have been changed as well. Hence, familiar brands such as Altria's Marlboro Lights and Reynolds American's Camel Lights must be changed to accommodate the ruling.[14]

It is interesting to consider broad global trends toward regulation in recent decades. At the global level, the period from World War II to the late 1980s was marked by increased trade protection. Many countries protected their industries by imposing tariffs, import duties, and other restrictions. Import duties in many Latin American countries ranged from less than 40 percent to more than 100 percent,[15] but this trend was not limited to developing nations. Countries in Europe and Asia—and even the United States—have imposed import fees on a variety of products, including food, steel, and cars. In the 1980s, the United States also convinced Japanese manufacturers to voluntarily restrict exports of

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TABLE 4-1 Selected Examples of Government Regulation of Business in the United States

Legislation	Purpose
Sherman Antitrust Act (1890)	Prohibits monopoly or conspiracy in restraint of trade
Clayton Act (1914)	Forbids contracts that tie the sale of one product to the sale of another
Federal Trade Commission Act (1914)	Stops unfair methods of competition, including deceptive advertising, selling practices, and pricing
Webb-Pomerene Export Trade Act (1918)	Permits selected U.S. firms to form monopolies in order to compete with foreign firms
Fair Labor Standards Act (1938)	Sets minimum wage rates, regulations for overtime pay, and child labor laws
Antimerger Act (1950)	Makes the buying of competitors illegal when it lessens competition
Equal Pay (1963)	Prohibits discrimination in wages on the basis of gender when men and women are performing jobs requiring equal skill, effort, and responsibility under similar working conditions
Clean Air Act (1970)	Directs the Environmental Protection Agency to create emission standards for potential pollutants
Occupational Safety and Health Act (1970)	Requires employers to provide a hazard-free working environment
Consumer Product Safety Act (1972)	Sets standards on selected products, requires warning labels, and orders product recalls
Equal Employment Opportunity Act (1972)	Forbids discrimination in all areas of employer–employee relations
Magnuson-Moss Act (1975)	Requires accuracy in product warranties
Foreign Corrupt Practices Act (1978)	Outlaws direct payoffs and bribes of foreign governments or business officials
Americans with Disabilities Act (1992)	Protects those who are physically and mentally disabled from job discrimination
Family and Medical Leave Act (1993)	Offers workers up to twelve weeks of unpaid leave after childbirth or adoption, or to care for a seriously ill child, spouse, or parent
Food Quality Protection Act (1996)	Reduces the amount of carcinogenic pesticides allowed in foods
Pension Security Act (2002)	Gives workers more freedom to diversify their investments and greater access to quality investment advice concerning their 401(k) plans
CAN SPAM Act (2003)	Prescribes rules and penalties for e-mail "spammers," although enforcement is difficult

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cars to the United States in lieu of a tariff. Interestingly, this particular tariff may be largely responsible for Japanese automobile manufacturers establishing a large number of production facilities in the United States, thereby blurring the concept of the "foreign car."

During this time, however, leaders from many nations recognized that all countries would likely benefit if trade barriers could be reduced across the board. After the end of World War II, twenty-three countries entered into the cooperative General Agreement on Tariffs and Trade (GATT), working to relax quota and import license requirements, introduce fairer customs evaluation methods,

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TABLE 4-2 Major Regional Trade Agreements

Agreement	Members
Asia-Pacific Economic Cooperation (APEC)	Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, South Korea, Taiwan, Thailand, United States
European Union (EU)	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom
North American Free Trade Agreement (NAFTA)	Canada, Mexico, United States
Asian Free Trade Area (AFTA)	Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand
Mercosur	Argentina, Bolivia, Brazil, Chile, Paraguay, Uruguay

and establish a common mechanism to resolve trade disputes. The World Trade Organization (WTO) and the International Monetary Fund (IMF) were also established at this time. By 1994, GATT membership had expanded to more than 110 nations when it was replaced by a new WTO. Today the WTO contains 147 members and continues to negotiate global trade agreements, although member nations must ratify the agreements before they become effective.

The move toward free marketing was also seen in Europe, where a number of nations banded together to develop a trade-free European community. Today, Europe is fast becoming a single market of 350 million consumers. The European Economic Area, as it is called, is the largest trading bloc on earth, accounting for more than 40 percent of the world's gross domestic product (GDP).[16]

Meanwhile, the United States, Canada, and Mexico established the North American Free Trade Agreement (NAFTA) to create its own strategic trading bloc. Many analysts believe that world business will eventually be divided into several such blocs, each providing preferred trading status to other nations within the bloc. Table 4-2 lists other important regional trade agreements.

This trend toward less regulation has even extended to the former Communist countries. As the nations of the former Soviet bloc in Eastern Europe overturned their governments, they began to open markets and to invite foreign investment.[17] The case of China is an interesting example to consider.

China is officially ruled by the Communist party, but its economic development policies have taken a distinctively free market approach since the late 1990s (see Case Analysis 4-1). In 2004, for example, McDonald's awarded its first franchise in China. The number of franchises awarded in China by McDonald's, Yum Brands (e.g., KFC), and others began to increase dramatically in early 2005 after Chinese officials introduced new guidelines concerning such issues as recruitment of entrepreneurs and property rights. These guidelines were required as a consideration of China's entry into the World Trade Organization. Previously, Western companies feared a loss of trade secrets and brands by offering franchises in China.[18] Regulation—or the lack thereof—always seems to be a key political and business issue, including the rather recently copyrighted products distributed electronically such as software, music, and movies.[19]

The political-legal environment can influence industries and firms in complex ways, especially when firms operate across borders. For example, Internet search firms Yahoo and Google must negotiate Chinese regulations in order to be successful there. The Chinese government believes that the Internet must be controlled to maintain social stability and thereby imposes strict censorship and

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Case Analysis 4-1

Step 5: What Political-Legal Forces Affect the Industry?

The political-legal forces that affect the industry depend on the industry, but should include the effects that political and legal events will likely have on the industry in which the organization operates. Key issues include but are not limited to the following:

1. Legislation at all levels
2. Court judgments, as well as decisions rendered by various federal, state, and local agencies
3. Environmental regulations and enforcement of antitrust regulations
4. Tax laws
5. Consumer lending regulations
6. Outcomes of elections
7. International trade regulations and tariffs
8. Laws on hiring, firing, promotion, and pay
9. Political stability

The focus at this point should be on the industry, not a specific firm. The application of the firm in question is discussed in the strengths, weaknesses, opportunities, and threats (SWOT) analysis in Chapter 9.

As with the other macroenvironmental factors (discussed in sections 4-3 through 4-5), some political-legal forces affect different firms in the same industry in different manners, but one should first identify the key macroenvironmental factors affecting the industry, and then explain how they affect the overall industry. For example, stating that a particular industry will be affected by changes in tax laws is not sufficient. One should first elaborate by discussing specific changes, such as an increase in the investment tax credit, and then elaborate on how this change affects the industry as a whole. Although referencing individual firms in this section is acceptable, emphasis should be placed on the effects of political-legal and other macroenvironmental forces on the *entire* industry. Specifics concerning how these factors affect a particular organization should be elaborated in the section on opportunities and threats, later in the analysis.

Researching political-legal forces, as well as other macroenvironmental forces, requires some digging and intuition, and a lot of reading. Rarely will one find a Web site that provides a comprehensive "macroenvironmental report" for a given firm or industry. When conducting research, it is often helpful to create four charts—one for each element in the macroenvironment—and add to it throughout the research process. One may locate direct and indirect references at the company home page and in various articles, but trade journals are often the best single source of information for reports on macroenvironmental issues. As many as two dozen (or more) different sources may be required to complete the analysis of the four macroenvironmental forces. It is rare that complete and thorough information can be found in only one or two sources.

If a company competes in multiple industries (with multiple business units), one needs to analyze the major business units and industries. What constitutes "major" depends on the firm. For example, Ford Motor Company receives the majority of its revenues from automobile sales, but it also has a business unit that provides customer financing. With Ford, it would make the most sense to analyze its automobile business unit and not spend considerable time on the financial business unit. With

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other companies, however, determining which business unit or units are "major" may be more difficult. The key is to consider the relative contribution of each business unit to corporate revenues and profits. If questions remain, it is a good idea to present the professor with a list of the company's business units and each one's proportion of company revenues and profits, along with a proposal on how to proceed, and ask for guidance.

security laws. This control represents a distinct challenge for the search engines, whose purpose is to enable users to access the full spectrum of information available, not just what governments prefer users to see.[20]

Pollution is also becoming more of a challenge every day in China's capital, Beijing, where nearly a thousand new cars are added to the congestion every day. In 2006, China had about twenty-five vehicles for every thousand people—seven of which were cars—roughly the proportion common to the United States in 1915. This is expected to change markedly, however, with some analysts predicting an increase from 33 million vehicles in 2006 to more than 130 million by 2020.[21] Hence, automakers should anticipate increased regulations in the coming years to combat this growing problem.

Trade restrictions across borders will always exist to some extent, especially in politically sensitive areas. For example, the United States and other Western countries have banned the export of advanced technology in certain circumstances. The United States prohibits the export of certain electronic, nuclear, and defense-related products to many countries, particularly those believed to be involved in international terrorism. Many of these restrictions were revised and strengthened following the 9/11 terrorist attacks.[22]

4-3 Economic Forces

Economic forces significantly influence business operations, including growth or decline in gross domestic product and increases or decreases in economic indicators such as inflation, interest rates, and exchange rates. Other factors such as hikes in energy prices and health care costs and access to labor can also play a role. These changes can present both opportunities and threats to strategic managers, depending on the industry.

Although the focus here is on the effects of economic changes on an industry, some competitors may be hurt more than others. Hikes in fuel prices in mid-2005, for example, did not have the same effect on all airlines, although specific effects are difficult to determine because of other simultaneous environmental and competitive changes in the industry. Initially, weak players such as Delta seem to have been hit the hardest, whereas budget carriers such as Southwest and Ryanair may have been able to experience mild gains. As prices continued to rise, however, it became apparent that low-cost airlines were not going to suffer less than their traditional counterparts because fuel represents a higher percentage of running costs on short-haul flights such as those championed by budget carriers. Low-cost airlines hoped to spread these increased costs over more customers with higher occupancy rates, but this became more difficult because traditional airlines began to lower fares in 2006 in an effort to increase their own occupancy rates.[23]

Economic forces can also have interesting cross-border effects. Toymakers in the West suffered during the 2006 Christmas season when power and labor

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shortages in China limited production of projected top sellers.[24] Hence, analyzing the political environment should not necessarily be limited to a firm's host country.

Several classes of economic forces tend to have broad effects on industries. The four classes discussed in this section are gross domestic product, inflation rates, interest rates, and exchange rates.

4-3a Gross Domestic Product

Gross domestic product (GDP) refers to the value of a nation's annual total production of goods and services. GDP is a key area of concern for all firms, but can become quite complex for those heavily involved in global markets. Although clear relationships exist among the world's economies, they do not always rise and fall together. For example, while GDP levels in the West were stagnant during the late 1990s and early 2000s, China's GDP grew at a staggering pace and provided expansion opportunities for a number of Western firms.[25]

Gross Domestic Product (GDP)
The value of a nation's annual total production of goods and services.

Consistent GDP growth generally produces a healthy economy fueled by increases in consumer spending. In contrast, however, a GDP decline signals lower consumer spending and decreased demand for goods and services. When GDP declines for two consecutive quarters, a nation's economy is generally considered to be in a **recession**, during which time competitive pressures can lower profits and increase business failure rates. Recessions do not threaten all industries equally, however. College and university enrollments often increase as undergraduate and graduate students seek to gain an advantage in a tight job market.[26] Likewise, "dollar" stores (i.e., those that price all products at one dollar) historically perform especially well during times of economic downturn.[27] Interestingly, after an extended growth surge, sales at dollar stores began to cool in 2004 and leveled off shortly thereafter. The dollar store industry appears to have entered the maturity stage of the industry life cycle. Such rivals as Family Dollar, Dollar Tree, Dollar General, Fred's, and 99 Cents Only can no longer anticipate increased earnings from sales growth.[28]

Recession
A decline in a nation's GDP for two or more consecutive quarters.

With dim prospects for rapid growth in the United States, certain dollar stores are moving abroad. California-based My Dollarstore operates only about fifty stores in the United States and holds a minuscule share of the market. It has expanded aggressively outside of the United States, however, and operates a couple hundred stores in Central America, Eastern Europe, and Southeast Asia where it faces less competition. My Dollarstores beat Wal-Mart to India, where it sells products for ninety-nine Indian rupees (about two dollars) and targets middle-class consumers.[29] The firm, though, must address a different set of macroenvironmental forces in each market it serves.

Source: Ablestock.com

A recession can also create opportunities for businesses. The deluge of dot-com failures in 2000 and 2001, for example, increased the supply of technical personnel at a time when demand for workers in this area was not being met. As a result, many traditional businesses were able to procure sorely needed technical expertise as software engineers and others became leery of dot-com start-ups.[30] Unfortunately, it is difficult to forecast a recession in advance, and many recessions are identified only after they have bottomed out.

4-3b Inflation Rates

High inflation rates have a negative effect on most but not all businesses. High rates raise many of the costs of doing business, and continued inflation constricts the expansion plans of businesses and triggers governmental action designed

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to slow economic growth. The U.S. Federal Reserve Board often raises its discount rate during inflationary periods to slow economic growth. Its counterparts in other developed nations typically follow suit, and in some cases precede Fed action.

An economic slowdown can have mixed effects on a particular industry as it affects interest rates. During a recession, for example, new car retailers tend to have a difficult time attracting prospective customers to their showrooms. However, slowdowns are often accompanied by central bank interest rate cuts, which in turn reduce both interest rates for consumers and bank costs that dealers must incur to finance their inventories. Hence, one needs to consider the composite impact that an economic factor may have on an industry, not only the single effect that may be most intuitive.

Like high interest rates, periods of inflation can present opportunities for some firms. For instance, oil companies may benefit during inflationary times if the prices of oil and gas rise faster than the costs of exploration, refinement, and transportation. Companies that mine or sell precious metals may also benefit during periods of inflation because such metals serve as inflation hedges for consumers.[31]

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4-3c Interest Rates

Short- and long-term interest rates affect the demand for many products and services, especially big ticket items with costs that are financed over an extended time, such as automobiles, appliances, and even major home renovations or repairs. At the consumer level, low short-term interest rates, for instance, are particularly beneficial for retailers such as Wal-Mart and J.C. Penney because they also tend to lower rates on credit cards, thereby encouraging consumer spending. At the corporate level, interest rates also influence strategic decisions related to financing. High rates, for instance, tend to dampen business plans to raise funds to expand or to replace aging facilities. Lower rates, however, are more likely to spawn capital expenditures on expansion and development.

Interest rates are closely linked to inflation rates. The cost of borrowing can be high in developing countries, with annual interest rates sometimes exceeding 100 percent. These high interest rates are often accompanied and influenced by excessive rates of inflation, as was the case in parts of Latin America in the 1990s. In small nations such as Bolivia, annual inflation has been as high as 26,000 percent.[32] Even larger and more industrialized countries such as Brazil have recently experienced annual inflation rates of 2,700 percent.[33] Routine decisions such as pricing and costing become almost impossible to make under such conditions. In addition, high inflation rates cause the prices of goods and services to rise and become less competitive in international trade.

A real estate boom fueled by low interest rates as much as doubled home values in many U.S. markets between 2000 and 2005, but when rates began to rise, builders began to reassess their strategies to ride out an anticipated downturn. Market leader D. R. Horton sold over 50,000 homes in the United States in 2005 and still plans to reach the 100,000 mark by 2010 even if the economy shows a downturn. Horton and other leaders believe they can prosper through any economic cycle by squeezing suppliers for lower costs and taking market share from smaller rivals.[34] This remains to be seen, however.

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4-3d Exchange Rates

Currency exchange rates can be influenced by international agreements, the coordinated economic policies of governments, and international economic conditions. When such conditions raise the value of the dollar, for example, U.S. firms find themselves at a competitive disadvantage internationally, as the prices of American-made goods rise in foreign markets. At the same time, American consumers may be inclined to purchase products that were produced abroad, which are less expensive than goods produced domestically.

When the dollar is strong, American manufacturers tend to locate more of their plants abroad and make purchases from foreign sources. However, when the dollar is weakens as it did in the mid-2000s, the financial incentive for American companies to purchase from foreign sources becomes more limited, and they tend to focus their activities more on the domestic markets.

Source: Ablestock.com

Currency exchange rates present challenges because of their dramatic and often unpredictable changes over time. For instance, the Mexican peso has been historically devalued relative to the world's major currencies once or twice every decade, reducing the profits of U.S. firms operating there. These rampant fluctuations began to subside in the late 1990s and early 2000s, but the future remains uncertain (see Case Analysis 4-2).

4-4 Social Forces

Social forces include such factors as societal values, trends, traditions, and religious practices. **Societal values** refer to concepts and beliefs that members of a society tend to hold in high esteem. In the United States and Canada, major values include individual freedom, fairness, free markets, and equality of opportunity. In a business sense, these values translate into an emphasis on entrepreneurship and the belief that one's success is limited only by one's ambition, energy, and ability. Interestingly, these values have attracted millions of immigrants to the United States and Canada during the past

Societal Values
Concepts and beliefs that members of a society tend to hold in high esteem.

Case Analysis 4-2

Step 6: What Economic Forces Affect the Industry?

Key economic forces that affect industry include but are not limited to the following:

1. GDP
2. Disposable personal income
3. Short- and long-term interest rates
4. Inflation
5. Exchange rates
6. Unemployment rate
7. Energy costs
8. Stage of the economic cycle
9. Monetary policy

As with other macroenvironmental forces, one needs to clarify specifically how these forces influence the industry in which the organization operates.

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centuries in search of religious, economic, and political freedom, resulting in a business environment that is more vibrant than in countries that do not hold similar values.[35]

American consumers value convenience. Increases in costs and inconveniences associated with health care have created opportunities for retailers. In 2005, Wal-Mart, Target, and CVS began testing medical clinics in select stores, whereby consumers could pay between twenty-five and sixty dollars and receive fast access to basic medical services without an appointment. Costs are trimmed by staffing the clinics with nurse practitioners, who are permitted to treat patients and write prescriptions in most states.[36]

Societal trends can have a keen influence on the rise and fall of industries. Today, the average American is older, busier, better educated, less likely to be a member of the Caucasian race than in previous years, more bargain conscious, and more technologically astute and Internet savvy.[37] The latter trend has had a profound effect on the demand for personal computers and educational services, and has led firms operating in the broad middle-age market to modify their strategic approaches to include either younger or older adults. Cosmetics maker Avon, confronted with a shrinking clientele, launched a major effort in 2002 to expand its appeal to the trendier sixteen- to twenty-four-year-old market.[38] In 2005, Gap launched ten test stores designed to target boomer women (currently in their forties and fifties), a category that typically spends less on apparel than younger adults.[39] Retailers such as J.C. Penney, May Department Stores, and Sears have begun to open stand-alone locations to provide easier access to customers too busy to plan a day at the mall.[40]

Source: Comstock.com

Societal trends also include demographic changes that can dramatically affect business opportunities. For example, the U.S. baby boom, which lasted from 1945 through the mid-1960s, initially provided opportunities for businesses such as clothing, baby apparel and diaper manufacturers, private schools, and candy and snack makers. Later, as the baby boomers entered the job market, universities and businesses were blessed with a tremendous pool of applicants. As they have continued to age, the baby boomers have begun shopping at home more and are spending vast sums of money for health care needs, leisure activities, and vacation alternatives.[41] Further, this population segment may not be as brand loyal as previous generations of Americans and represents a key group of purchasers of goods and services on the Internet.[42]

Demographic changes have taken a toll on American Express. Long known for catering to older, more affluent executives, American Express is having a difficult time reaching members of a new generation to whom the prestige of having an AmEx card means little or nothing. Between 1984 and 2004, the number of credit cards in circulation in the United States rose from fewer than 200 million to over 600 million, and the number of debit cards grew from zero to over 200 million. In an effort to permeate the credit and debit card fog among young consumers, American Express even began offering unusual perks targeted to young prospective cardholders, such as free chocolate martinis and discounts at trendy nightspots.[43]

Societal trends present various opportunities and threats to businesses. For example, the health and fitness trend that emerged in the 1990s has spawned growth in manufacturers of fitness equipment, as well as producers of health drinks, while hurting certain businesses in less health-friendly industries such as tobacco and liquor. In 2002, Anheuser Busch launched Michelob Ultra, a

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low-carbohydrate beer, in an effort to tap the health-conscious market.[44] Also in 2002, PepsiCo announced it would attempt to increase its sales of healthy snacks, including baked and low-fat offerings, to 50 percent of its total snack food sales.[45]

Other consumer-related trends have been sparked by development of the Internet. In the early 2000s, a number of traditional retailers began to experience sales declines as more consumers shopped online. Online retail sales in the United States have risen rapidly in recent years. Purchases of big ticket items such as furniture and appliances have also grown as consumers have become more comfortable making large purchases via the Internet, creating opportunities for retailers such as Best Buy and Circuit City.[46]

Buyer behavior is a key concern, especially for retailers. Traditional department stores such as Sears, J.C. Penney, and Dillards suffered revenue declines in the late 1990s and early 2000s as a result of changes in consumer buying habits that favor discounters such as Target and Wal-Mart, and e-tailers such as Amazon.com. Department stores have responded by streamlining stores to facilitate faster service, modifying product lines to target specific consumer groups, and even increasing their reliance on private label brands.[47]

Increases in online sales have caused traditional retailers to develop new ways to attract prospective buyers to their stores. They discovered that many consumers were less likely to frequent a traditional retailer unless it also provided some form of entertainment value. Bass Pro Shops, for example, increased its store traffic substantially by including such amenities as a large fish tank, live bats, and even a rock-climbing wall. Mall developers began to include "activity zones" in their facilities for such attractions as skating and fitness centers. This trend of mixing retailing with entertainment is expected to continue in the coming years.[48]

Trends toward socially responsible manufacturing and waste management practices, as well as concerns for saving private wetlands from business development, should be noted as well.[49] Specifically, the last decade of the twentieth century witnessed a heightened interest in both consumer recycling and the production of recyclable products by manufacturers in the United States and other parts of the world. To address this shift, Norwegian recycling giant Tomra expanded to a couple hundred recycling kiosks in California in 2001. The cleaner, more accessible kiosks are designed to appeal to socially sensitive consumers who prefer not to deal with the inconveniences associated with the traditional recycling centers.[50] However, many analysts note that consumers are often unwilling to pay the higher prices typically associated with environmentally friendly products.[51]

The tragic events of 9/11 spawned social changes that affect a variety of industries. For example, concerns over air travel safety have greatly influenced everything from routes to marketing strategies of major airlines. Broadly speaking, Americans are more willing to accept inconveniences associated with their transactions if they believe that safety and security are heightened as a result. Studies also suggest that investment and personal life strategies have become more conservative and reflective as a result of the tragedy.[52] Even churches are taking notice, as the 25 percent increase in national attendance immediately following the events of 9/11 had all but disappeared by early 2002.[53]

Sections 4-4a and 4-4b develop in detail changes in two key social forces, eating habits and automobiles. These examples illustrate both the richness and the complexity of social change and how it affects firms. Section 4-4c elaborates on global concerns.

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4-4a Case 1: Eating Habits

A key social force affecting several industries in the United States and worldwide is the changing of eating habits. One can argue that some firms in food-related industries have achieved success primarily on the basis of a single social force. Since its founding in 1980, Whole Foods Markets grew to 189 stores and $5.6 billion annual sales in twenty-five years as the largest U.S. organic and natural foods grocer. CEO John Mackey has demonstrated that the natural and organic food movement is not merely a fad, but one that is substantial enough to support a national grocer. Of course, Whole Foods Markets faces potential threats associated with this movement. If it declines, the grocer will most likely suffer. Alternatively, if it becomes mainstream, traditional grocers will continue to expand their natural and organic food product lines, increasing competition for the firm.[54]

Food producers understand the value of staying abreast of changes in consumer tastes, especially in terms of diet fads and health trends. While food sales have grown at a modest clip of about 2 percent annually, sales related to diet fads rise and fall rapidly, rewarding firms with the right array of products. In the mid-2000s, companies such as Nestle, Unilever, and Kraft began experimenting with special starches and fibers to create foods that make people feel full for a longer time. If successful, such products could lead to an overall reduction in food sales, creating an interesting conundrum for these companies.[55]

Interestingly, American consumers have been sending a mixed message of the celery stick and the double chocolate peanut swirl for the past decade, further complicating the task of identifying demand patterns for restaurants and packaged food producers alike. American and British women between the drinking age of twenty-one and twenty-four, for example, consumed 33 percent more alcoholic beverages in 2004 than they did just five years earlier, a trend likely connected to the fact that women are starting families later in life and therefore have more disposable income at this age.[56] Alcoholic beverage producers are responding with new alternatives targeted to the taste preferences of young women.

Responding to shifts in alcoholic beverage consumption patterns is not always easy, however. In late 2005, Anheuser Busch teamed up with notable Harvard epidemiologist Meir Stampfer to tout the potential medical benefits of beer consumptions. Stampfer cites studies suggesting that moderate consumption of alcohol may reduce the risk of heart attack, diabetes, and other ailments. Between 1995 and 2004, beer's share of the overall consumption of alcoholic beverages in the United States declined while wine's share increased. Although Anheuser Busch attributes some of this shift to the preference for beverages low in carbohydrates, the firm believes that a key factor is a misconception that moderate wine consumption can be healthy whereas moderate beer consumption is not.[57]

In the late 1990s and early 2000s, fast-food consumers began eating less at traditional giants such as Burger King, Pizza Hut, and Taco Bell, in favor of more healthy alternatives such as Subway and Panera Bread. Although competitors such as McDonald's have responded with more salads, expanded advertising campaigns, a rotation of temporary items, revamped dollar menus, and even credit card service, the company's "fried" image remains intact and sales increases have been difficult to muster.[58] In the fast-food business, rapid and effective adaptation to changes in taste can spell the difference between profit and loss. In the mid-2000s, tastes shifted from hamburgers and chicken to toasted sandwiches. Subway equipped its stores with high-tech ovens and began offering consumers

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the option of toasting their sandwiches. Rivals took similar measures as the sale of sandwiches grew at twice the pace of burgers.[59] Even as U.S. fast-food icons continue to expand abroad, restaurant chains from other parts of the world, such as Guatemala's Pollo Campero and Mexico's El Tizoncito, are expanding into the United States.[60]

During the past several years, many fast-food restaurants have been "supersizing" their meal combinations by adding extra fries and larger drinks, while at the same time expanding alternatives for items such as grilled chicken sandwiches and salads.[61] In 2004, Coca-Cola and PepsiCo began to emphasize smaller cans and bottles (at higher per-ounce prices),[62] while McDonald's introduced low-carb menu items.[63] Eating habits even changed markedly after the U.S.-led war with Iraq began as Americans consumed large quantities of high-calorie takeout food while watching war coverage on television.[64]

In early 2005, the U.S. government released a revised design of the *food pyramid,* a graphical depiction reflecting food choices the U.S. Dietary Guidelines Advisory Committee believe to be appropriate. Whether this attempt to communicate dietary guidelines more effectivly to consumers will be successful remains to be seen.[65] With the introduction and reported success of products such as the Hardee's Monster Thickburger with 107 fat grams and 1,418 calories, the extent to which many American consumers consider health factors when purchasing fast food is not clear.[66]

Traditionally, food in China has been viewed as something to be savored, not rushed. Only about 10 percent of business at fast-food restaurants in China is takeout. KFC (Yum Brands) opened its first drive-thru in China in 2002 and added a second in 2005, but response has been lackluster. McDonald's opened its first drive-thru in China in 2005 and partnered the following year with Sinopec, China's largest gasoline retailer, to build a large number of additional units in Sinopec service stations. With the faster pace of Chinese life and more cars on the road, McDonald's is banking on acceptance of the drive-thru concept (in Chinese, *De Lai Su*, which translates into "come and get it fast"). This move reflects an increased effort by McDonald's to tailor its offerings more to local tastes. Chicken outsells beef at McDonald's in China, where the fast-food giant blends the traditionally favorite Big Macs and fries with local favorites such as corn, spicy chicken wings, and triangle wraps (chicken or beef mixed with rice and vegetables in a tortilla-type wrapper).[67]

In late 2003, concern about obesity in developed nations such as the United States and the United Kingdom became more pronounced. Critics charge that sedentary lifestyles and unhealthy foods have led to increases in diabetes, heart disease, and other medical problems associated with obesity. Many charged that food processors and fast-food restaurants such as McDonald's have contributed to this phenomenon by encouraging individuals to consume larger quantities of unhealthy foods.[68] At the same time, however, a number of food producers and restaurants began catering to consumer interest in low-carbohydrate regiments as dieter concern shifted from fat content in foods to carbohydrate content. Unilever, for example, began promoting low-carb Skippy peanut butter, Wishbone dressing, and Ragu spaghetti sauce.[69]

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4-4b Case 2: Automobiles

Social trends can drive consumer markets as, for example, in the automobile industry. The 1990s experienced the rise of sport utility vehicles (SUVs) on the American automotive landscape. By the end of the decade, SUVs were the

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vehicle of choice for many suburban families, and the minivan was passé. Auto manufacturers realized, however, that the new breed of SUV patrons was willing to give up some of the rugged features associated with the SUV in exchange for the additional space and softer ride associated with the minivan. As one GM executive put it, "The sport utility today is kind of becoming like the minivan, a family vehicle." In early 2001, Ford responded to the shift in consumer preferences by introducing a redesigned Explorer with three rows of seats, additional safety gadgets, and a softer ride.[70] By 2003, Ford, General Motors, and Nissan had begun to shift attention away from large SUVs to the hybrid vehicles they termed "crossovers" or "active lifestyle wagons."[71] Ford executives even called 2004 "the year of the car" in anticipation of a consumer move away from SUVs, trucks, and minivans.[72]

The evolution of the sport utility vehicle continued into the mid-2000s, as demand for traditional SUVs such as the Ford Explorer and the Chevrolet Tahoe leveled off in the United States. In 2005 and 2006, sales of crossover vehicles began to surpass those of SUVs in the United States. Crossovers are typically smaller and more fuel efficient than SUVs, but many grew wider and longer during this time, adding such features as a third row of seats, more cargo space, and greater towing capacity.[73] The 2006 models boasted designs that resembled a combination of SUV and sports car, station wagon, or mini van. Experts attributed the changes to both a greater interest in practicality and the reality of higher fuel prices.[74]

Spikes in fuel prices in the mid-2000s took a heavy toll on sales of fuel-inefficient vehicles, including SUVs. When gasoline prices in the United States approached three dollars per gallon, GM reported a sales decline of 24 percent over the same month in 2004, while Ford sales dropped 19.5 percent. Meanwhile, sales at Chrysler, which is less dependent on SUVs, rose 4 percent. Sales at Toyota, makers of more fuel-efficient vehicles, rose 10 percent during the same period, led by a 23 percent increase in sales of the gas-electric hybrid Prius.[75] Fuel prices eventually tapered off, but rose abruptly again the following year. By mid-2006, American automobile manufacturers and retailers were forced to respond with incentives worth thousands of dollars to move its less fuel-efficient vehicles from inventories.[76] In July 2006, sales at Toyota in the United States surpassed those of Ford for the first time.[77] In 2007, Chrysler announced plans to introduce its tiny, two-seat SmartForTwo in the United States in 2008. The SmartForTwo is only 106 inches long, compared to 150 inches for Toyota's subcompact Yaris and 202 inches for Chevrolet's Tahoe. Although the vehicle has enjoyed some success in Europe, serious questions remain about the viability of such a small car in the United States.[78]

Interestingly, however, the popularity of the SUV in the United States has been attacked on the grounds of another social force—environmental responsibility. Opponents charge that SUVs are simply too large and fuel inefficient, increasing the nation's dependence on external sources of oil and potentially compromising the nation's ability to broker a lasting peace in the oil-rich Middle East. Interestingly, some experts are predicting a decline in the SUV fervor during the mid-2000s.[79] Nonetheless, SUV manufacturers still face a daunting task of balancing environmental concerns and their desire to produce a vehicle still in demand.

Consider additional social changes related to automobile preferences. Led by European automakers, manufacturers began developing smaller premium vehicles for sale in the United States in the mid-2000s, a period during which demand for less-expensive, fuel-efficient, high-end cars is expected to rise.

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Interestingly, the role of the "Big Three" American carmakers in the development of these vehicles has been indirect rather than direct, with primary activity coming from General Motor's Saab, Ford's Volvo, and DaimlerChrysler's Mercedes divisions.[80]

Following the 2005 hike in gasoline prices in the United States, GM and Ford began to promote their "flex-fuel" vehicles that can operate either on gasoline or E85, a mix of 15 percent gasoline and 85 percent ethanol. The automakers announced plans to produce 650,000 fuel-flex vehicles annually and push for more service stations that carry the alternative fuel. In 2005, approximately 5 million such vehicles—mostly GM and Ford products—were in operation in the United States, but E85 was not easy to find, especially outside of the Midwest. Not only are fuel-flex vehicles attractive to environmentally friendly consumers, but they also represent a competitive advantage for the giant American automakers. When GM and Ford launched a new focus in 2006, Nissan was the only Japanese carmaker with a compatible product on the market, a version of its large Titan pickup.[81]

4-4c Global Concerns

It is difficult to separate domestic social forces from global forces. Indeed, the analysis of social forces can be quite complex for firms operating in several countries.[82] Each of the world's nations has its own distinctive **culture**, its generally accepted values, traditions, and patterns of behavior. These cultural differences can interfere with the efforts of managers to understand and communicate with those in other societies. The unconscious reference to one's own cultural values as a standard of judgment—the **self-reference criterion**—has been suggested as the cause of many international business problems. Individuals, regardless of culture, become so accustomed to their own ways of looking at the world that they often cannot comprehend any significant deviation from their perspective. However, companies that can adjust to the culture of a host country can compete successfully.[83] For instance, by adapting to local tastes rather than rigidly adhering to those of its U.S. customers, Domino's has found profitable business overseas by selling tuna and sweet corn pizzas in Japan and prawn and pineapple pizzas to Australians.[84]

Culture
A society's generally accepted values, traditions, and patterns of behavior.

Self-Reference Criterion
The unconscious reference to one's own cultural values as a standard of judgment.

Progressive companies recognize that cross-cultural differences in norms and values require modifications in managerial behavior. For example, business negotiations may take months or even years in countries such as Egypt, China, Mexico, and much of Latin America. Until personal friendships and trust develop between the parties, negotiators are unwilling to commit themselves to major business transactions.[85] In addition, Japanese business executives invite and even expect their clients or suppliers to interact socially with them after working hours, for up to three or four hours an evening, several times a week. Westerners who decline to attend such social gatherings regularly may be unsuccessful in their negotiations because these social settings create a foundation for serious business relationships (see Case Analysis 4-3).

Societal trends can vary widely among nations, especially as they relate to other factors. For example, throughout the 1990s and early 2000s, smaller cars were the vehicles of choice in Europe, where roads are narrow, gasoline is heavily taxed, and fuel economy is a greater concern than in the United States. In contrast, U.S. consumers continued to demand relatively larger vehicles in a country where roads are wide, gasoline is much less expensive, and fuel consumption does not play as strong a role in the purchase decision.[86] Fashion in China also

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Case Analysis 4-3

Step 7: What Social Forces Affect the Industry?

Key social forces that affect the industry include but are not limited to the following:

1. Societal traditions
2. Societal trends
3. Prevailing values
4. Consumer psychology
5. Society's expectations of business and consumer activism
6. Concern with quality of life
7. Expectations from the workplace
8. Religious trends and values
9. Population and demographics
10. Birth rates and life expectations
11. Women in the workforce
12. Health consciousness
13. Attitudes about career and family

As with other macroenvironmental forces, but especially with social forces, it is important to outline how each key force has affected the industry and organization to date, and to address how each will likely influence the industry in the future. For example, health consciousness and dual-career couples have spawned the demand for Healthy Choice microwavable dinners. Will these two social forces change in the upcoming years? If so, how?

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illustrates how social trends vary across borders. In China, preferences reflect a mix of Asian, American, and European tastes.[87]

Societal traditions define societal practices that have often lasted for decades or even centuries, but changes can occur. For example, the celebration of Christmas in the Western Hemisphere provides significant financial opportunities for card companies, toy retailers, turkey processors, tree growers, mail-order catalog firms, and other related businesses. In fact, many retailers hope to break even during the year and generate their profits during the Christmas shopping season. The popularity of Christmas is increasing in China. Although Chinese celebrations are typically devoid of religious significance, opportunities have emerged for marketers and merchandisers seeking to cash in on the popularity of gifts, consumption, and Santa Claus.[88]

Strategic managers of U.S. corporations should remember that their firms have exceptionally high visibility because of their origins in the United States. As such, citizens of other countries may disrupt the business operations of U.S. corporations as a form of anti-American activity. Only two months after Euro Disneyland opened in France, many French citizens decried the venture. Hundreds of French farmers blocked entrances to the theme park with their tractors to express displeasure with cuts in European farm subsidies that had been encouraged by the United States, even though 90 percent of the food sold at the park was produced in France.[89]

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4-5 Technological Forces

Technological forces include scientific improvements and innovations that create opportunities or threats for businesses. The rate of technological change varies considerably from one industry to another and can affect a firm's operations as well as its products and services. A number of businesses have used advances in computer technology such as computers, satellites, and fiber optics to perform their traditional tasks at lower costs and higher levels of customer satisfaction. Many analysts believe satellite radio for cars will revolutionize the automobile audio entertainment industry.[90]

Technological change can decimate existing businesses and even entire industries because it shifts demand from one product to another. Historical examples of such change include the shifts from vacuum tubes to transistors, steam locomotives to diesel and electric engines, fountain pens to ballpoints, propeller airplanes to jets, and typewriters to computers.[91] Internet icon Shawn Fanning spawned an "online music swapping" industry with his launch of Napster, a service whereby patrons could exchange music files via the Internet. Copyright and legal complications, however, forced a shutdown and sale of the business.[92]

Source: Comstock.com

The pace of adopting a technological change is not always easy to predict and can even be influenced by competing technologies. For example, high-definition radio technology became pervasive in the early 2000s and a couple hundred U.S. radio stations were broadcasting digital radio by the end of 2004. However, the first radios capable of using the new standard were originally priced as much as $1,000 at a time when demand for lower priced satellite radios was growing rapidly. Many analysts believe that digital radios will become commonplace by the late 2000s, but the specifics are difficult to predict.[93]

Advances in technology can substantially influence production costs associated with a product or service. Television manufacturer limitations in sizes of glass sheets they can handle, for example, kept prices for flat-screen televisions high throughout 2004 when many analysts had predicted production costs to drop.[94] Food and meat producers such as ConAgra Foods, Hormel Foods, and Perdue Farms are dunking prewrapped foods into tanks of pressurized water, a technique that enables vendors to keep deli meats in the pipeline for as long as one hundred days.[95]

Many retailers are beginning to utilize technology to better understand how buyers shop. Consumer research firm ShopperTrak RCT, for example, tracks shoppers nationwide using forty thousand hidden cameras in stores and shopping malls. The firm sells the data it collects to retailers, economists, and banks, all of which desire more insight into purchase trends.[96]

The widespread use of the Internet over the past decade is arguably the most pervasive technological force affecting business organizations since the dissemination of the personal computer (see Strategy at Work 4-1). The effects are most profound in select industries, such as brokerage houses, where online companies have demonstrated huge gains in the market, or the travel industry, where the number of flights, hotels, and travel packages booked over the past decade has skyrocketed. The Internet has also spawned the advent of online banking, a much less costly means of managing transactions. As such, by 2002, a number of major banks and creditors had begun encouraging customers to pay bills online by offering free software, elimination of fees, and even sweepstakes entries with each transaction.[97] Indeed, the Internet has had a major effect on virtually every industry in the developed world.

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STRATEGY AT WORK 4-1

Leveraging Technological and Social Forces at Knight-Ridder and McClatchy

Founded in1903, Knight-Ridder was originally a traditional print newspaper company, publishing such newspapers as the *Miami Herald* and the *Akron Beacon Journal*. It later purchased numerous newspapers including the *Detroit Free Press*, the *Philadelphia Inquirer*, and the *San Jose Mercury News*. Knight-Ridder was at one time the nation's second-largest newspaper publisher, with thirty-two daily newspapers in twenty-eight U.S. markets and a readership of 8.5 million daily and 12 million on Sundays. Like other U.S. newspapers, however, Knight-Ridder faced readership declines as consumers obtain information from other media outlets, most notably the Internet.

As the Internet developed, Knight-Ridder took advantage of technological innovations to expand its information network. The company's Internet operation, Knight-Ridder Digital, was created as a separate business unit in 2000 to create and maintain a variety of innovative online services, including Real Cities, a major national network of city and regional destination sites in fifty-eight U.S. markets. Knight-Ridder Digital was launched to provide local information on the Web, including regional searchable hubs, city resource Web sites, online newspapers, vertical channels, directories, online shopping, entertainment and recreation sources, merchant storefront building, classified services and archives, and special interest Web sites. Knight-Ridder also acquired CareerBuilder Inc. and CareerPath.com Inc. to create a powerful local and national online recruitment network.

The company was also cognizant of changing social forces, successfully capitalizing on an opportunity provided by demographic changes in Miami several years ago. Observing the ever-increasing number of Cuban Americans in the Miami market, Knight-Ridder launched a Spanish-language paper, *El Nuevo Herald*, which immediately became a success and is now one of the largest of its kind in the United States.

Adjusting to these changes was not easy, however, and Knight-Ridder struggled to remain competitive. In 2006, rival McClatchy acquired Knight-Ridder and later sold some of its papers. Like Knight-Ridder, McClatchy also seeks to respond to changes in technology, working closely with Yahoo in a partnership that includes content sharing and cross-advertising.

Sources: P. Callahan, "Student Papers Are Resisting Gannett's Push onto Campuses," Wall Street Journal Interactive Edition, *21 February 2002; Knight-Ridder Corporate Web site, www.knightridder.com, accessed 14 March 2002; P. Wright, M. Kroll, and J. A. Parnell,* Strategic Management: Concepts *(Upper Saddle River, NJ: Prentice Hall, 1998).*

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Consider the airline industry. With the advent of the Internet, many consumers began to purchase their airline tickets online instead of utilizing the traditional intermediary, a travel agency. As airlines began investing in this much more efficient means of ticketing in the 1990s, they started to trim commissions paid to travel agencies for booking their flights. In 2003, the major U.S.-based airlines followed Delta's lead and eliminated commissions altogether for tickets sold in the United States, except where specially negotiated arrangements existed between the airline and the agency. Travel agencies have moved aggressively to the Internet and to expand volume. A number of agencies were dissolved during this period.[98]

Interestingly, Internet travel agencies such as Orbitz, Travelocity, and Expedia thrived during this time. These sites invest heavily in promotion and emphasize convenience, ease of use, and access to the "best deals." Unlike traditional travel agents, these online competitors aggressively target hotel reservations and have sparked feuds with large hotel chains that attempt to lure customers to their own Web sites for bookings. Hotel chains charge that online travel agents inflate room rates by as much as 30 percent, thereby discouraging potential customers and cutting into hotel profits. Online agents contend that they offer value to customers by increasing choices.[99]

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On the consumer side, over 1.1 billion individuals have access to the Internet, most residing in the United States, Canada, Europe, or Asia. Reports also suggest that the majority of America's population shops online. Most online shoppers tend to be male, married, college educated, and between eighteen and forty years of age.[100] Online retail spending for 2007 exceeded $100 billion, growing at an average annual rate of about 24 percent.[101]

Technology has spawned major changes in the customer service arena. Many of the touch-tone consumer hotlines of the 1990s were replaced in the early 2000s by "virtual agents" that answer calls and use speech recognition technology to either resolve a question or transfer the customer to a "real person" who can. Studies suggest that these systems improve response time by as much as 40 percent. Whereas some consumers appreciate the increased speed and are enamored by many agents' use of accents and even flirtatious personalities, others feel awkward about "talking to a computer pretending to be a person." Interestingly, some U.S. companies have addressed this frustration by utilizing fewer technology-based systems and transferring incoming calls to their consumer hotlines and technical support centers directly to representatives in countries such as India, where labor costs are much lower.[102]

Technology also affects global business operations. For example, by 2003, 40 percent of the vehicles sold in Europe were powered by more fuel-efficient, cleaner, and more advanced diesel engines. In contrast, most transfer trucks in the United States consumed diesel fuel. Following renewed concerns over the political situation in the Middle East where much of the world's oil is produced, America's "Big Three" carmakers began to apply this technology to SUVs produced in the United States.[103]

Technology's effect on global business can also be viewed from a development perspective. For years, manufacturers in technologically advanced nations established operations in developing countries with low labor and raw material costs. These expansions have generally been welcomed because they bring financial resources, opportunities for workforce training and development, and the chance for the host country to acquire new technologies. In many cases, this interaction has benefited the developing country over the long term, most notably in the cases of emerging nations such as Mexico, Brazil, India, and China.[104]

Leaders in emerging nations are not always satisfied with the results of global business expansion, however, because anticipated economic and social benefits do not always materialize, such as specialized business development assistance, the establishment of research and development (R&D) facilities, and the hiring of locals in managerial and other professional positions.[105] On-the-job training notwithstanding, the overall long-term contribution to the host country is sometimes questioned by leaders in the developing nations (see Case Analysis 4-4).

Changes in technological and social forces often work together to influence an industry. In the last two decades, for example, the proliferation of segmented television networks and the emergence of the Internet have led to a decline in newspaper readership—particularly among younger readers—as busier professionals pursue information outlets in the "new media," including those facilitated by the Internet and talk radio. Many advertisers in newpaper classifieds have shifted to Internet sites or eBay. Daily newspaper readers in the United States peaked at 62.8 million in 1985 but declined to 54.6 million in 2005. As a result, many newspapers have launched targeted

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Case Analysis 4-4

Step 8: What Technological Forces Affect the Industry?

Key technological forces that affect the industry include but are not limited to the following:

1. Effect of the Internet
2. Scientific improvements
3. Inventions
4. Technology affecting production
5. Expenditures on research and development
6. Focus on R&D expenditures
7. Rate of new product introductions
8. Automation

youth-oriented publications and have begun to leverage the power of the Internet in an effort to regain readers.[106]

4-6 Environmental Scanning

Environmental Scanning
The systematic collection and analysis of information about relevant macroenvironmental trends.

Maintaining currency in macroenvironmental forces that affect one's firm can be a daunting task. **Environmental scanning** refers to the systematic collection and analysis of information about relevant macroenvironmental trends. Surveys of Fortune 500 firms generally indicate major payoffs associated with their environmental-scanning activities, including an increased general awareness of environmental changes, better strategic planning and decision making, greater effectiveness in governmental matters, and proper diversification and resource allocation decisions. However, the respondents often indicate that the results of their environmental analysis are typically too general or uncertain for specific interpretation.[107] Hence, the need for *effective* environmental scanning to produce relevant information is critical.[108]

Britain's leading retailer, Tesco, uses a "Clubcard" to collect data on its customers and tailor products and promotions specifically for individual customers. Tesco has leveraged this approach to increase its share of the grocery market in the United Kingdom to 31 percent in 2006, compared to 16 percent by Wal-Mart's Asda chain. Asda in the United Kingdom accounts for about 10 percent of Wal-Mart's overall revenues and almost half of its international sales. Tesco is using its knowledge of shoppers and customer preferences to combat Wal-Mart's emphasis on low prices.[109]

Some specialized firms presently offer environmental-scanning services to strategic managers by providing them with real-time searches of published material associated with their industries. Top managers at many smaller firms rely on publications such as the *Wall Street Journal* to remain abreast of changes that may affect their firms.

Source: Ablestock.com

Top managers often have difficulty maintaining objectivity when they evaluate information because they selectively perceive their environment through the lens of their own experiences and organizational strategy. One study concluded

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that the heads of financial institutions that emphasize cost minimization tend to focus their monitoring activities on competitors and regulators. By contrast, scanning activities in financial institutions that seek to differentiate themselves from their competitors are more likely to focus on opportunities for growth and customer satisfaction.[110]

Interestingly, environmental scanning often identifies relationships among key industry influences in two or more forces. For example, technological advances in the early to mid-2000s enabled manufacturers to produce handheld devices for viewing DVDs at a price level suitable to a significant number of consumers. Interest in the product was further enhanced by heightened consumer interest in both DVDs and portable electronic products in general. When French firm Archos began producing such a product, however, it ignored an anticopying code found on a majority of prerecorded DVDs, enabling consumers to use the product to make illegal DVDs. Although there were no laws in place prohibiting Archos from ignoring the code, filmmakers began to exert political pressure to lobby for legislation to protect their copyrights.[111] Interestingly, this occurred at a time when Time Warner's HBO began to emphasize the sale of DVDs in addition to subscription fees as a means of enhancing revenues.[112]

Today, the main problem created by environmental scanning is often one of determining which available information warrants attention. For example, it is not uncommon for a major U.S. firm to be referenced in over a thousand news stories in a given week. For small organizations and for those competing in global markets, however, it may be difficult to obtain reliable information on environmental conditions and trends. In China, for example, research house Euromonitor International reported that 23 billion liters of soft drinks were consumed in 2002, whereas a Coca-Cola study concluded the level to be 39 billion liters. Discrepancies such as this create great difficulties for managers attempting to make informed strategic decisions.[113]

4-7 Summary

Four macroenvironmental forces affect every industry. Political-legal forces include various forms of legislation and judicial rulings, such as the decisions of various commissions and agencies at all levels of government. Economic forces include the effects of elements such as GDP, inflation, interest rates, and exchange rates. Social forces include traditions, values, societal trends, and a society's expectations of business. Technological forces include such factors as the Internet, as well as scientific improvements and innovations that affect firm operations and products and services in a given industry. Although each industry is affected by all four sets of macroenvironmental forces, the relative influence of the four forces can vary substantially by industry. Environmental scanning is the process of researching and analyzing macroenvironmental changes.

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Key Terms

culture
environmental scanning
gross domestic product
macroenvironment
PEST
recession
self-reference criterion
societal values

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Review Questions and Exercises

1. Explain how changes in interest rates affect the automobile, home construction, and auto repair industries.
2. Give an example illustrating how social trends present both opportunities and threats to businesses in high-tech industries.
3. Give an example illustrating how the Internet has presented an opportunity or a threat to a particular industry or business organization.
4. Using your college or university as an example, explain how political-legal, economic, technological, and social forces have affected its operations over the past decade.
5. Select a large firm with which you are at least somewhat familiar. Utilize the search engines at www.findarticles.com and identify important macroenvironmental opportunities and threats for this company.

Practice Quiz

True or False

1. It is unusual for a single firm to influence a macroenvironmental force.
2. A decline in GDP negatively affects all industries.
3. In many respects, social forces are the drivers of consumer markets.
4. The expansion of a religion in an emerging country is an example of a social force.
5. Reading business publications can serve as a means of environmental scanning.
6. Environmental scanning can be difficult for large firms because of the availability of too much information.

Multiple Choice

7. The acronym referring to the analysis of macroenvironmental forces is
   - **A.** WASP.
   - **B.** PEST.
   - **C.** STOP.
   - **D.** SERCH.
8. At the global level, the period from World War II to the late 1980s was marked by
   - **A.** an increase in trade protection.
   - **B.** a decrease in trade protection.
   - **C.** an absence of U.S. imports.
   - **D.** none of the above
9. When the value of the U.S. dollar increases, U.S. firms
   - **A.** compete at an advantage in foreign markets.
   - **B.** compete at a disadvantage in foreign markets.
   - **C.** tend to decrease exports to nations whose currencies are directly tied to the dollar.
   - **D.** none of the above
10. Technological forces often
    - **A.** decimate an entire industry.
    - **B.** spawn new industries.
    - **C.** vary substantially among industries.
    - **D.** all of the above
11. Which of the following is *not* an example of a social force?
    - **A.** trends
    - **B.** values
    - **C.** industrial change
    - **D.** All of the above are examples.
12. When a recession occurs
    - **A.** all industries benefit.
    - **B.** some industries benefit.
    - **C.** no industries benefit.
    - **D.** none of the above

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READING 4-1

Insight from *strategy+business*

It is important for all firms to understand a key social force—how potential buyers make purchase decisions. Hirsh and associates examine the process by which cars are evaluated and purchased. They argue that the perceived value and performance levels associated with a brand ultimately govern the purchase decision.

Reality Is Perception: The Truth about Car Brands

Expensive advertising cannot compensate for weak brands and undifferentiated products.

By Evan Hirsh, Steve Hedlund, and Mark Schweizer

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A strong car brand can create significant value in the automotive industry. The price consumers expect to pay for otherwise identical luxury vehicles can vary as much as $4,000, depending on the car's brand. For mass-market cars, brand helps determine which products a consumer considers buying. Furthermore, superior brands extend their halo across every model of vehicle within the brand. It's no surprise that most auto manufacturers make brand positioning and development a key item on their marketing agenda.

Yet despite intense interest in their power, automotive brands remain relatively poorly understood. Why do car brands have such value in a business that is clearly product driven? How do brands acquire their value? What causes their value to wax or wane over time?

Because of the prominent role that brand positioning and development play in many auto manufacturers' business strategies, we conducted extensive research and analysis to better understand how consumers think about car brands. Our analysis uses standard statistical techniques to distill multiple brand image attributes (drawn from Allison-Fisher International LLC surveys of car buyers) into a small set of underlying factors, which provide valuable insights into consumer brand perceptions. (See "Research Methodology," section at the end of the reading.)

Our research shows that consumers have a simple yet sophisticated understanding of what differentiates car brands. Notwithstanding automakers' attempts to distinguish their brands on the basis of lifestyle or emotional imagery, consumers evaluate brands in terms of their earned reputation for product excellence relative to their total ownership cost. Consumers' perceptions are based on their accumulated direct and indirect experience with the products that constitute those brands.

These perceptions are obviously not perfect. Some brands' reputations exceed or fall short of their demonstrable product attributes. But, as a rule, consumers' beliefs are accurate, stable, and relatively immune to manipulation. In contrast to the situation with other consumer goods, in which equity is created substantially through advertising, automotive brand perceptions change primarily through consistent and sustained changes in the underlying product portfolio.

Within this overarching conclusion, we were able to identify five central insights that are critical to understanding how, and to what extent, manufacturers can enhance and leverage the value of their brands.

1. **Virtually all of the difference in how consumers perceive competing brands can be explained by their relative performance against two holistic measures: product excellence and cost.**

Traditionally, car manufacturers have tried to measure their brands across a large number of image attributes, hoping to develop additional insights about brand differentiation. However, consumer perceptions of a brand's reputation are generally consistent across different measures of value. For example, consumers believe that manufacturers whose car lines have a reputation for luxury and prestige tend to produce cars that excel in many other areas, such as ride, handling, safety, and reliability. In fact, a brand's score on any one attribute tends to be so highly

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correlated with its score on another attribute that these scores can be integrated into one measure that represents a car line's propensity to create excellent products.

Consumers also have a sophisticated understanding of product cost. They recognize that vehicles differ not only in their initial purchase price, but also in their expected maintenance and operating costs, as well as their ultimate resale value. Together, these different types of expenditures determine the total cost to the consumer over the ownership cycle. As with the product excellence dimension, the various attributes that determine a brand's expected ownership costs can be integrated into a single measure of product cost.

These two holistic measures, product excellence and cost of ownership, account for 91 percent of the difference in how consumers perceive automotive brands. (See Exhibit 1.) In fact, these two holistic measures are comprehensive enough to predict the consumers' overall opinion of the brand with an extremely high degree of accuracy.

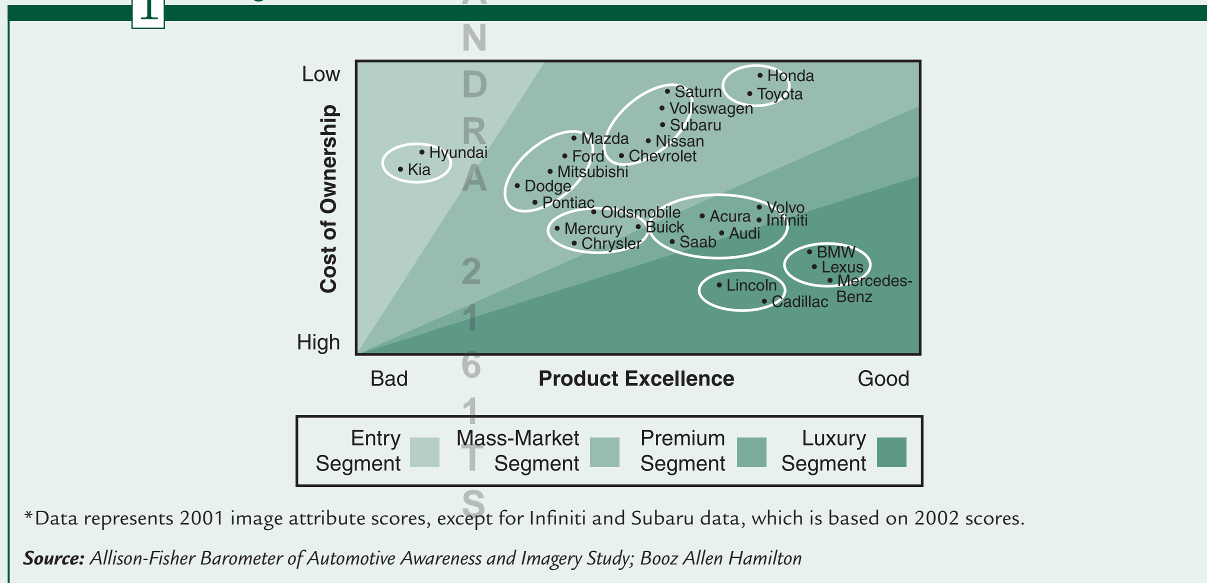
Of the remaining variation in consumer perceptions, roughly half (or 5 percent) is due to specific attributes such as "sporty." These secondary attributes are not highly correlated with other attributes and cannot be included in the holistic measure of product excellence. With the exception of a few outliers (for example, BMW, whose reputation rests in part on its sportiness), most brands tend to be relatively undifferentiated along these secondary attributes.

2. Consumers are not only elegantly simple in their view of automotive brands, they are acutely rational as well.

For the average consumer, a new car is second only to a new home in the size of the transaction, the length of the ownership cycle, and the potential to reaffirm and communicate an individual's sense of self-worth. Consequently, consumers spend a substantial amount of time evaluating their alternatives. In addition to their own firsthand experience, they consult a number of sources, from the anecdotal evidence of friends and family, to independent reviews by magazines, industry groups, and government agencies, to the manufacturers' marketing communications, including brochures, measured media, and owner events.

It's true that some brand reputations, particularly in the mass-market segment, don't keep lockstep pace with actual changes in the products. But in general, consumers are well informed, and their opinions accurately reflect the accumulated performance of the products that are the physical embodiment of those brands. For example, the cost-of-ownership brand measure is highly correlated with actual cost of ownership. Similarly, consumers' perceptions of a brand's reputation for durability, reliability, and workmanship (which are key constituents of the holistic product excellence measure) are highly correlated with the actual dependability of that brand's vehicles.

EXHIBIT 1 Average Performance of Car Brands*



*Data represents 2001 image attribute scores, except for Infiniti and Subaru data, which is based on 2002 scores.

Source: *Allison-Fisher Barometer of Automotive Awareness and Imagery Study; Booz Allen Hamilton*

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3. The relative magnitude of product excellence and low cost of ownership determines a brand's value proposition in the marketplace.

Consumers recognize that, in general, better products cost more. Consumers self-select an automotive segment on the basis of which attribute (cost of ownership or product excellence) they value more. Within a consumer's chosen segment, brands that deliver more of both attributes provide superior value to the consumer.

As a result, brands can differentiate themselves in two fundamental ways: by providing a different proportion of product excellence to cost of ownership (i.e., segment selection); and by providing more or less performance across both attributes (within the boundaries of the chosen segment). The result is a production function that's a classic trade-off between product excellence and cost of ownership, with the frontier defined by brands providing the most value in each segment.

It is possible to group brands using statistical clustering techniques, so that grouping definitions minimize the differences within clusters and maximize the differences between clusters. These clusters represent groupings of brands that consumers believe offer comparable *amounts* of product excellence and low cost of ownership. Consumers perceive that brands in a cluster offer a value proposition similar to those of other brands in the same cluster and materially different from those in different clusters.

This is not to argue that brands within the same cluster are identical. Brands can partially differentiate themselves on the basis of secondary attributes. BMW has carved a niche within the luxury segment based on its image as the "ultimate driving machine" that offers superior acceleration, turning, and handling. Likewise, Subaru has partially differentiated its reputation within the mass-market segment on the basis of the security of all-wheel drive.

Channel performance (e.g., dealership experience and product availability) can also be used to differentiate a brand. Saturn stands out for having good customer service and providing a pleasant buying experience. However, the majority of brands are not meaningfully differentiated on any basis other than product excellence and cost of ownership.

4. Brands in crowded, weakly positioned clusters tend to suffer from eroding margins.

Brands positioned closer to the lower left-hand corner of Exhibit 1 (i.e., those with higher cost of ownership and lower product excellence) offer less value to consumers. Such brands naturally tend to achieve lower purchase consideration and hence volume. A large number of such brands within the mass-market segment are competitively disadvantaged relative to other brands within the same segment and relative to brands in neighboring segments, as Exhibit 1 shows.

For vehicle manufacturers with large capital investments, this situation is untenable. They must seek to improve at least one of the two holistic brand measures for their brands. Because improvement of a brand's product excellence is difficult to accomplish across an entire product portfolio and generally requires up to a decade, the only way for brands to improve their positioning quickly is to lower product prices and offer customers better cost of ownership.

By contrast, Honda and Toyota have clearly distanced themselves from the rest of the mass-market segment. In the consumer's mind, Honda and Toyota represent a combination of product excellence and cost of ownership that so far surpasses all other competitors that they operate along a different trade-off curve. While not yet in the same league, several other brands, such as Volkswagen, Saturn, and Subaru, have also separated themselves from the rest of the pack.

5. Brand positions tend to change relatively little over time.

Consumer perceptions are shaped in large part through accumulated product experience, both first-hand and indirect. Consumers also use a large number of objective sources of information to supplement their direct product experience (e.g., word of mouth, product reviews, and safety ratings). As a result, the perception-forming process is long and relatively immune to simple manipulation by the manufacturer, in contrast with most consumer goods, whose brand equity is created substantially through advertising.

Although marketing communications certainly play an important role in what consumers think, the only way to sustain meaningful change in automotive brand perceptions is with ongoing, consistent changes in the underlying product experience. Furthermore, since brand value is a function of performance relative to the brand's competition, significantly altering brand perceptions requires a manufacturer to systematically improve its entire product range faster than its competitors do.

Over the past two decades, most manufacturers have made concerted efforts to improve product quality, develop new features, and reduce costs. They have used

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various techniques, such as computer-aided design, system outsourcing, and component reuse, to speed up the product development cycle, reducing the time it takes to respond to competitors' innovations. As a result, it is increasingly difficult for manufacturers to improve their products continuously at a rate that outpaces the market.

Doing so requires a coordinated strategy and a concerted effort. In the late 1990s, Volkswagen deployed a steady stream of new products to significantly shift consumer perceptions of its brand. VW leveraged product and process technologies that had been developed for Audi in such areas as engine packaging, powertrain, chassis tuning, advanced material forming, and tight tolerance assembly. The result was a slate of products, including the Jetta, Passat, and New Beetle, that offered superior ride, handling, styling, and assembly quality at a reasonable cost. Furthermore, the migration of Audi process and product technologies to VW did not erode consumers' perceptions of the Audi brand. However, recent reports of cross-model quality problems (e.g., ignition coil faults) could serve as the reversal point of VW's recent brand improvement journey.

Like VW, the Hyundai and Kia brands have benefited from a sustained flow of new products that offer significantly improved quality, attractiveness, edgy styling (at times), and extremely low cost of ownership due to low sticker prices and extended warranty coverage. The resulting value proposition has not only increased these brands' unit volume, but also has radically changed consumers' perceptions of the brands. What is stunning is how much the Korean brands have improved in such a short time, especially in comparison with how long it took Toyota and Honda to shake their reputation for producing tin cans. If the Korean brands continue to improve their reputation for product excellence while maintaining their cost of ownership, they could leapfrog the Big Three mass market brands to join the cluster currently defined by VW, Nissan, and Saturn.

In contrast, the value of Saturn's brand has been deteriorating. Saturn was initially able to transfer consumers' satisfaction with the dealer experience to the product. Although Saturn still remains differentiated on the basis of its channel performance, the product has failed to satisfy consumers' expectations for quality, and the brand as a whole has experienced significant erosion.

Like Saturn, the Buick, Oldsmobile, and Mercury brands demonstrate the impact that a consistently weak product line has on brand value. In their heyday, Buick and Oldsmobile represented the quintessential premium brands – steps above Chevrolet and only a notch or two below Cadillac. Several generations of product that were rebadged versions of mass-market vehicles, and the growth in market penetration of alternatives such as Volvo and, more recently, Audi, undermined the value position of the Buick, Oldsmobile, and Mercury brands.

Mercedes-Benz and BMW have both delivered significant improvements in cost of ownership over the past decade. In part, this was caused by direct pricing pressure from Japanese luxury brands (most notably Lexus). However, we believe a large portion of the difference is due to a change in product mix to include more entry-level luxury vehicles (e.g., BMW's 3 series and Mercedes's C-class). As these brands have shifted their center of mass toward "entry luxury," so has consumer opinion shifted.

Marketer's Checklist

Few manufacturers have the resources required to implement such a sweeping overhaul of their product portfolio. Consequently, brand positions tend to change relatively little over time. Furthermore, it is far easier to erode brand equity than it is to build brand equity. Product missteps, gaps in the product pipeline, and intentional efforts to shift a brand's customer base can lead to significant deterioration in brand value.

The five findings detailed above have profound implications for most manufacturers.

- Tangible product differentiation is both critical to success and difficult to maintain on a sustained basis. A key focus of the marketing function should be to rigorously understand consumers' preferences, unmet needs, and willingness to pay, in order to maximize the "hit rate" on innovative products.
- Minimizing cost of ownership (both up-front acquisition cost and long-term ownership cost) within the segment boundary is critical. The marketing function must take an active role in balancing the drive toward lower cost of ownership with the consumer value created through innovative features and options.
- Lifestyle and emotional imagery cannot compensate for weak brands and undifferentiated products. Consumers may acknowledge a brand's "personality," but the aspects of the brand that drive consumer shopping behavior are promises that the brand represents for product excellence and cost of ownership. Image advertising and lifestyle and event marketing may help to accelerate consumers' understanding of the brand, but it cannot fundamentally change the promise. Consequently, the

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number of resources applied toward lifestyle and image advertising should be scrutinized for appropriateness and effectiveness.
- For mass-market vehicles, incentives are a symptom of a weak brand—not the cause. In the absence of a strong brand, price is the only plausible way to affect near-term demand. Hence, curtailing incentives in an effort to “build brand” is not likely an economically viable option.

Many manufacturers have made brand positioning and development a key item on their marketing agenda. Yet brands are not the product of manufacturers' marketing efforts. Instead, consumers base their understanding of an automotive brand's value on their accumulated experience with that brand's products. If you want to change the brand, change the products—for the better.

Research Methodology

Our research is based on data from the Allison-Fisher Barometer of Automotive Awareness and Imagery Study (the primary source is the “Car Makes” study, which is supplemented with the “Light Vehicle” study to include Saab and Infiniti). The research and conclusions are specifically for cars. Allison-Fisher surveys car buyers on their attitudes, focusing on 24 specific attributes: excellent handling, excellent ride, excellent workmanship, good looking, good warranty program, good customer service, good safety for occupants, high trade-in value, prestigious, luxurious, really dependable, sporty, technically advanced, fun to drive, excellent acceleration, lasts a long time, name you can trust, viewed as a leader, satisfying sales experience, trend-setting vehicles, economical to operate, excellent gas mileage, good value for the money, reasonably priced.

We employed standard statistical analysis (factor analysis) to identify which of these image attributes correlate with each other and to distill the 24 attributes down to a small set of underlying, uncorrelated factors, or “meta-attributes.” Attributes with a 60 percent correlation were considered part of the same factor. Two underlying meta-attributes emerged from this distillation: product excellence and cost of ownership.

In order to further validate the dual meta-attribute model, we employed standard regression analysis techniques to demonstrate the meta-attributes' ability to predict brand opinion. The results confirmed the model and demonstrate very strong predictive power (R^2 = 96%) for the model.

After identifying the two factors and determining each brand's scores on the two meta-attributes, we detected clusters of brands. These clusters not only match our intuition of how the automotive market is segmented, but are statistically valid (based on cluster analysis, another standard statistical technique).

To study how brands have changed over time, we looked at historical image attribute data, limiting ourselves to the subset of image attributes that were consistently available across the entire past decade. The original analyses (factor analysis and clustering) were repeated on this subset of image attributes and conducted on the full decade-long set of data. Brand position evolution was then studied to see which brands showed both significant (i.e., large magnitude relative to others) and consistent (i.e., same year-to-year trend) movement.

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Real-Time Case 5: AutoZone

Joseph "Pitt" Hyde opened the first Auto Shack auto parts store in 1979 in Forrest City, Arkansas. Having served on the board of directors at Wal-Mart for seven years, Hyde adopted the giant retailer's model and concentrated on smaller markets in the South and Southeast, emphasizing service and everyday low prices. The auto parts retailer enjoyed early success and grew to almost 200 stores by 1984. Shortly thereafter, the Duralast private label was launched and the company changed its name to AutoZone. By 1991, the retailer had amassed nearly 600 stores and went public. Sales topped $1 billion in 1992.

John Adams replaced Hyde as CEO and chairman in 1997. In 1998, AutoZone acquired Chief Auto Parts, converting its 560 stores, mostly in California, into AutoZones the following year. The company also acquired Adap's 112 Auto Palace stores in the Northeast. In the early 2000s, emphasis shifted from acquisition to internal growth. In 2003, AutoZone amassed 12 percent of the $36 billion do-it-yourself (DIY) automotive aftermarket. By 2004, AutoZone had grown into the leading automotive aftermarket retailer with over $5 billion in annual revenues.

AutoZone stores sell parts under a variety of brand names and private labels and offer diagnostic testing services, but they do not sell tires or perform repairs. A typical store stocks over 20,000 parts. Most AutoZone stores are freestanding, with the remainder located in strip malls.

AutoZone targets the DIY consumer with cars more than seven years old (i.e., what the company calls OKVs—"our kind of vehicles"). Today, the company also continues to grow its do-it-for-me business by selling to professional repair shops through its AZ Commercial program, although not all stores participate in this endeavor. Future prospects for both segments bode well for AutoZone, however, as the DIY segment is expected to grow at a rate of about 5 percent over the next decade, whereas the do-it-for-me segment is expected to grow at a rate of 6 percent.

William Rhodes became CEO in 2005 and began revitalizing its stores. He mandated one of two standard layouts in all stores at a cost of about $5 million (about $2,000 per store). Storefronts were dedicated to luring in potential customers rather than a haphazard array of products selected by each individual manager. Rhodes's program has shown some initial signs of success.

Today, AutoZone operates more than 3,800 retail auto parts stores in the United States and about 100 in Mexico. Advance Auto Parts is number two in the industry with over $3 billion in sales and about 3,000 stores. Other key competitors include Pep Boys, CSK, and O'Reilly, as well as discount retailers such as Wal-Mart and Target. AutoZone emphasizes internal growth, opening about 150 to 200 additional stores per year.

Perspectives

- "Pep Boys hit speed bump on auto service," *Mercury News*, 2 September 2004. Unlike AutoZone, rival Pep Boys both sells auto parts and offers service for customers who do not wish to complete the work themselves. Pep Boys, however, has reported declines in the service side of its business.
- Howell, D., "Rallying the troops to get back into the profit zone," *DSN Retailing Today*, 6 September 2004. Much of AutoZone's success may be linked to its unique merchandising approach, including unusual mixes of products through the stores.
- Condon, B. "Cheapskates," *Forbes*, 19 June 2006. AutoZone's store revitalization—spearheaded by CEO William Rhodes—is showing signs of improving performance, in terms of both sales and (primarily) profits.

Case Challenges

- Is automotive aftermarket retail an attractive industry? Why or why not?
- How can AutoZone differentiate itself from rivals O'Reilly Automotive and Advance Auto Parts?
- Is international expansion an attractive alternative for AutoZone? Why or why not?

Internet Sites of Interest

- Corporate Web site: www.autozone.com
- Web sites of key competitors: www.advanceautoparts.com, www.pepboys.com, www.napaonline.com
- Automotive Aftermarket Industry Association: www.aftermarket.org
- Automotive Parts Rebuilders Association: www.apra.org

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