Eco380: Managerial Economics I

Competitive Strategy

Simon Board

Thursday 2–4, Autumn 2006

Eco380, Competitive Strategy

Competitive Strategy: Week 1

Introduction and Industry Analysis

Simon Board

Yours Truly

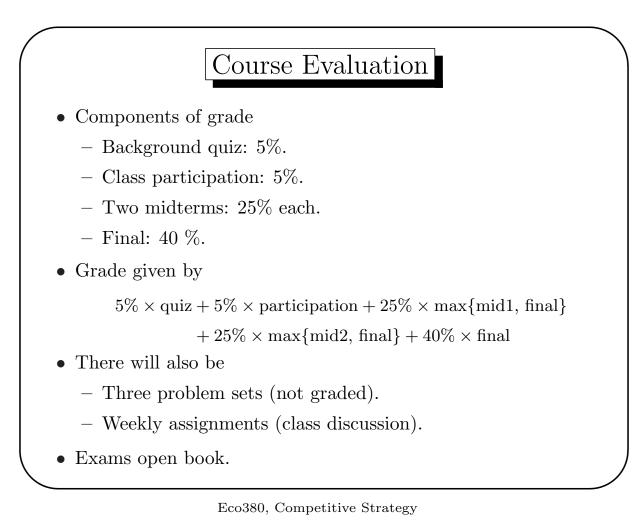
- Education
 - B.A. Caius College, Cambridge.
 - M.Phil. Nuffield College, Oxford.
 - Ph.D. Graduate School of Business, Stanford.
- Research: Auctions, Bargaining and Pricing.
- UTM Office: K112G
- Office hours: Thursday 1.00-2.00 or after lecture.
- Email: sboard@utm.utoronto.ca. I will reply to emails on Monday afternoons.

Eco380, Competitive Strategy





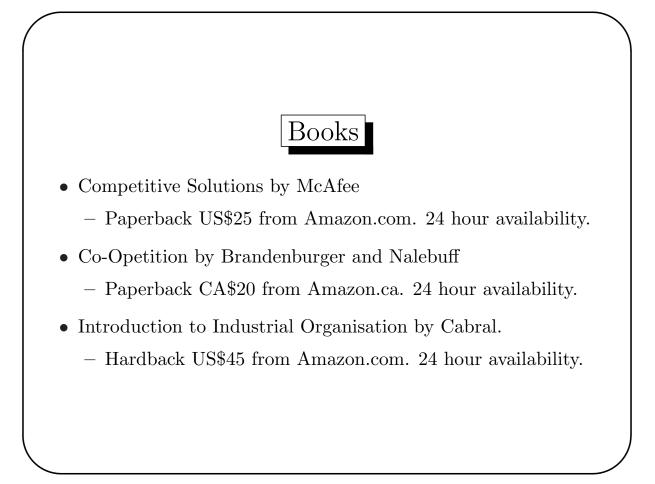
- This course will
 - Identify determinants of competitive advantage.
 - Develop strategies to take advantage of these opportunities.
 - Build toolkit of methods to evaluate different strategies.
- At the end of the course, students should be able to
 - Recognise major strategic problems.
 - Understand what elements of the environment are crucial.
 - Suggest how participants may change the game.





Assumed Knowledge

- Economic concepts:
 - Basics: perfect competition, monopoly pricing.
 - Industrial organisation: Bertrand competition, Cournot competition, Stackelberg competition (i.e. leader-follower).
 - Game theory: Nash equilibrium, backwards induction.
- Mathematical concepts:
 - Optimisation: constrained and unconstrained.
 - Basic statistics: mean, variance, distribution functions.



Eco380, Competitive Strategy

Cooperation vs. Competition

- Value of industry = Buyer value Supplier cost.
- This pie is shared between the firm, customers, suppliers and other firms.
- Business is cooperation
 - Cooperate with other parties to make pie as big as possible.
- Business is competition
 - Compete over share of the pie.
- Business is *both* cooperation and competition at the same time.

 $\overline{7}$

The Value Net

- Components: [see picture]
 - Our Firm
 - Customers
 - Suppliers
 - Competitors
 - Complimentors
- Interactions create and divide the pie.
- Notice symmetry:
 - Increase pie by increasing buyers' values of reducing suppliers' costs.
 - Tradeoff: The customer is *not* always right.
 - Example: Should staff give up holidays to serve customer?

Eco380, Competitive Strategy

Industry Analysis

- Identify factors determining industry profitability.
- Foundation for strategic analysis.
- Context for formulation of strategy.
- Analysis depends on market definition.
- Links between products A and B depend on links between value nets.
 - Products compliments/substitutes
 - A firm is in both markets
 - Contracts span markets (e.g. products are bundled).

Porter's "Five" Forces

1. Substitutes

- 2. Buyer bargaining power
- 3. Supplier bargaining power
- 4. Rivalry
- 5. New entrants
- 6. Compliments

Eco380, Competitive Strategy

11

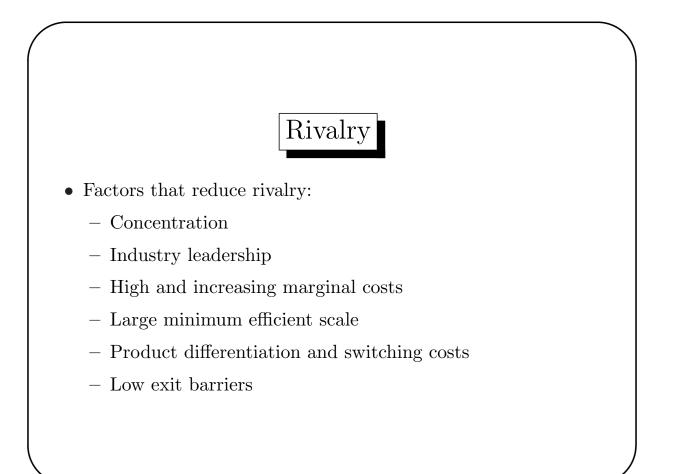
Substitutes

- Two types of substitutes:
- 1. Goods outside the market being considered.
 - Limit the valuations of buyer.
 - Can be very broad: more leisure time is substitute for a car.
 - Strategic interactions not directly considered.
- 2. Goods inside the market being considered.
 - Affects how our firm interacts with competitors.
 - Depends on product differentiation.
- Product is often blind-sided by substitute outside immediate market (especially with new technology)
 - IBM and Microsoft/Intel
 - Microsoft and Internet.

Buyer/Supplier Bargaining Power

- Consider relationship between firm and supplier.
 - More on bargaining in week 13.
- How big is pie?
 - Potential pie = value of relationship.
 - Ex-post costs of negotiation: lawyers fees, delay, strikes.
 - Ex-ante costs of negotiation: underinvestment in relationship, cultivation of outside options.
- How is pie split?
 - Long side vs. short side of market
 - Power to commit to one stance
 - Perceptions, perceptions of perceptions, perceptions of perceptions,...

Eco380, Competitive Strategy



Rivalry: Industry Structures

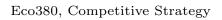
- Fragmented (e.g. dry-cleaners)
 - Little strategy unless market changes (e.g. home depot).
- Dominant firm (e.g. Microsoft)
 - Biggest danger: entrants with new technology.
- Tight oligopoly (e.g. Coke and Pepsi)
 - $-\,$ Much scope for cooperation and competition.
- Loose oligopoly (e.g. car firms)
 - Strategy to maximise value added.
- What determines structure?
 - Cost structure, transactions costs, regulation.

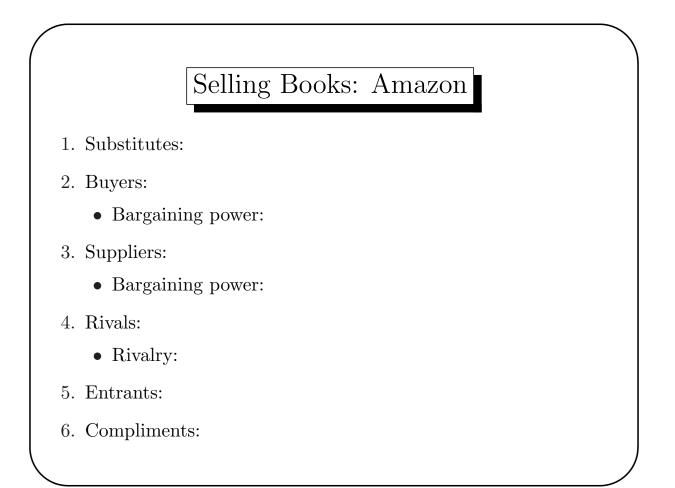
15

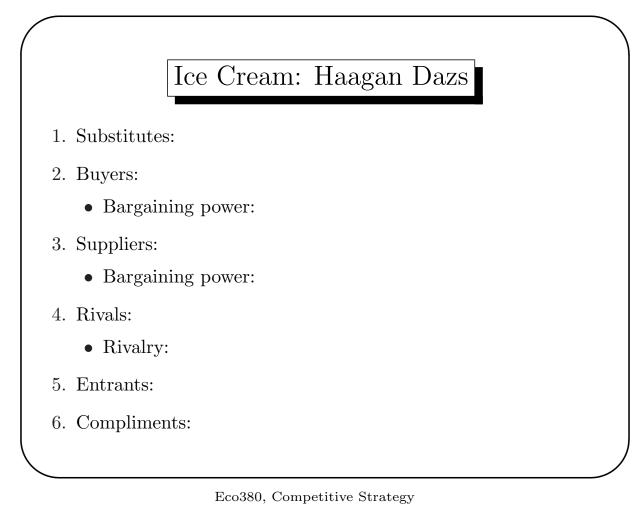
New Entrants More on this in week 6. When should you fight entry? When preemptively block entry? Some barriers to entry: Government (USPS, Taxis, Patents) Large MES (Intel, Boeing) Product uniqueness e.g. loyalty, switching costs (Banking) Network Externality (Microsoft) Reputation (Nutrasweet) No room for entry (Cereals)

Complimentors

- Complimentors make the pie bigger.
- Petrol, cars and roads
 - Michelin makes maps and tour guides
 - In 1913 General Motors built "seedling miles" or road
 - In 1919 General Motors created financing arm
- Video recorder and movies
 - Sony Betamax had few rentals
- Mall economics
 - Toys R Us and McDonalds
- Operating systems, software and hardware









Market Definition

- How define market for Vespa?
 - Scooters? Motorbikes? Cars? Public Transport?
- Case Study: Epson
 - Epson dominated low–end dot–matrix printers.
 - HP dominated the Inkjet and high–end laser printer market.
 - Epson is in the wrong market \rightarrow launched competitive laser printer in 1989.
 - Price War!
 - Laser printer prices $\downarrow.$ Inkjet prices $\downarrow.$ And dot–matrix market...?
- Lesson: There always a bigger market.

Coherent Strategies

- Porter (1996). Strategy is:
 - Creating unique and valuable position.
 - Making trade-offs. Choosing what *not* to do.
 - Creating fit among activities, doing many things well.
- Systems of activities:
 - Choices compliment each other.
 - Hard to imitate: can't copy piecemeal.
 - Increases value added.
 - Danger: in desire to grow firms can forget what makes them unique.
- Potential Counter Example: Budweiser B^E .

21

Case Study: Toyota

- In 1950s, Toyota was small Japanese car firm.
 - Little capital, no scale economies.
 - Couldn't mimic American mass production.
- Just-in-time manufacturing
 - Inventories act as buffer, but subject to large economies of scale.
 - Toyota reduced inventories via close coordination.
- Reliability of process
 - Without buffer of inventories, engineers worked on reliability of every step of production line.
- Fewer flaws in product
 - Problems noticed immediately, rather than sitting in inventories.

Toyota cont.

- Suppliers
 - Little scale, so can't produce in–house.
 - Communicate on day–to day basis.
 - Long term relationships.
- Skilled workers trained to fix own machines.
 - In US, this was specialised job.
- Flexible machines, due to lack of scale.
 - Leader in use of robots.
- Frequent redesigns possible
 - Because of flexibility of production line.
- Strategies are complements.

Modern Manufacturing		
	Mass Production	Modern Manufacturing
Varieties	Small	Large
Machines	Specialised	Flexible
Workers	Specialised	Multiple tasks
Inventories	Large	Just-in-time
Authority	Centralised	Decentralised
Communications	Infrequent, top-down	Fast, bidirectional

Assignment

- Read: "The Future of Fast Fashion", Economist, 18th June 2005.
- What market is Zara targeting?
- What differentiates Zara's products from its competitors?
- What is special about Zara's production process?
- Is Zara's strategy coherent?
- We will discuss this case next week!

Eco380, Competitive Strategy