*Strategic Management*, 9e: Chapter 3 study guide

The nature and intensity of competition in an industry

Although the work developed by Professor Porter has made a real contribution to strategic thinking, it is important to understand that it was grounded in earlier studies on industrial organisation economics (often called I-O economics). This stressed the importance of stable structural barriers limiting competitive entry and enriching firms already in the industry. The famous work is captured in the text: Bain, JS (1956) *Barriers to New Competition*, Harvard University Press, Cambridge, Mass.

Governments will set the basic degree of competitiveness that they wish to see in industries. Having established this, it is useful to start any analysis of competition with Porter’s *Five Forces Analysis* (*see* Chapter 3). This will provide a basic starting point in any development of the major factors driving the dynamics of the industry.

In addition to such an analysis, it is possible to examine the nature and degree of concentration of companies in a market. In microeconomic theory, the degree of concentration of companies in a market can be seen as being somewhere between two extremes, each of which will have strategic consequences for companies:

 perfect competition

 pure monopoly

In *perfect competition*, there are numerous buyers and sellers, with no single firm able to influence market prices: it is assumed that products are identical in every respect and that the firm accepts the price set by the market. The perfectly competitive firm sets its level of production output to maximise profits. From a strategic viewpoint, this leaves the firm at the mercy of market pressures and is therefore undesirable. It would be much better strategy for the firm to *differentiate* its product, dominate a sector of the market and thus influence that sector’s market price – in other words, to gain sustainable competitive advantage.

At the other extreme to perfect competition, there exists the state of *pure monopoly.* In this case, there is no competition and the company has total control over its prices; it erects barriers to entry and maximises profits and value added. It does this at the expense of its customers, but from a strategic management viewpoint it might be argued that the corporation has no responsibility to such customers and should seek to maximise profit and value added regardless of their views: strategies would therefore include raising prices to the maximum that the market will bear and setting output accordingly.

In practice, for many companies the environment is neither one of perfect competition nor one of pure monopoly. For example, Boo.com had many competitors over the Internet, but there were some that were more important than others. Strategic management needs to deal with a wide range of industrial structures in the middle. For some industries where there are economies of scale, it may be more efficient for the state and more profitable for individual companies to have a few large companies in an industry – that is, *an oligopoly.* Strategic management in such industries will therefore be directed towards obtaining and sustaining the oligopoly if this is possible.

Industry structure and market characteristics have a significant impact on strategic management. However, the actions that companies take go well beyond the pricing activity often highlighted in microeconomic theory – for example, cost reduction, product differentiation, linkages with other companies through alliances and joint ventures. At Boo.com, pricing was clearly important but there were a whole range of factors associated with its fashion products that would also attract buyers. In the chapters that follow, these areas will be explored further.

The *concentration ratio* is often used to measure the degree to which value added or turnover is concentrated in the hands of a few or many firms in an industry. It is usually defined as the percentage of industry value added or turnover controlled by the largest four, five or eight firms – the C4, C5 or C8 ratio, respectively. Typically, C5 averages around 55 per cent in UK manufacturing industries and C4 averages around 34 per cent in US industries.

Chapter 5 explores some important additional issues that can then be explored. These are explained in Chapter 5.