Strategic context of the firm

Why are some firms more profitable than others? To figure this out, we need to answer a related question. Why do firms exist? Top to its essence, the answer is simple. Firms exist to create value for its customers. That eventually is what leads to increased shareholder value. But what is the starting point of creating value for customers? That starting point is, in fact, the customer himself.

Consider the example of a company starting an air travel service from point A to B. Let's assume X as the cost of making this service available. In provisioning this service, the firm creates a certain amount of value for its customers. This value is in effect a combination of both tangible and intangible factors and this is what makes the customer willing to pay for the services. This is the process of value creation.

However, as you will appreciate, it is not enough to create value. To survive and grow, a firm needs to retain a portion of the value that it created. The maximum of that value created can be termed as willingness to pay. This assumes a business as usual situation. In extraordinary situations, willingness to pay may be extraordinarily high. In actual practice, though, our airline will not charge the customer all of what she is willing to pay. We will set a price, keeping in mind several factors, such as the target market share, alternate travel options, offerings by competitors, etc.

The final price that we then decide on sets the context for the value capture process. When a firm's activities allow it to create and capture value, it has competitive advantage or in other words, the ability to deliver superior performance compared to its competition.

Note that this advantage may be lost eventually, because others tend to copy, imitate, or in other ways, eliminate your advantages. It can also be lost due to internal organizational factors such as inefficient processes or culture.

The essence of strategy is about a firm's ability to create value for its customers, and capture some of that value that it creates to ensure its own survival and growth and to do this year on year, endlessly. That is a source of sustainable competitive advantage and therefore, superior performance.

However, there is a problem here. The problem is that when we examine firm performances, we find significant variations within the same industry and across industries. For instance, consider the findings of an analysis carried out by my students using data provided by

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Aswath Damodaran of NYU. You will observe significant differences across industries. While information service, software, household products, insurance and so on show very high returns, aviation, utilities, oil and gas and steel show very low returns. What explains these differences?

So we come to one of the most important questions in strategy. Why are some firms more profitable than others? This was also a question that troubled Michael Porter, a young HBS professor in the late

70s. His research on this was later to turn him into the rock star of this strategy world. Drawing upon the industrial organization's theory, Porter's insight was that the average levels of profitability in any industry is a function of the industry's structure.

What is an industry structure? Porter constructed industry structure around the various actors in the industry. Various actors in the industry influence how the industry works. That is how value is created, captured, or managed or in other words, the industry's profitability. Bad industry structures lead to very low levels of attractiveness and therefore, low profitability.

So who are these actors? How do we map industry structure? Let's go back to our example of the airline company. First, there are input suppliers, suppliers of labor, fuel, aircraft manufacturers, suppliers of capital such as banks, leasing firms, airports, government mandated services and so on. They are part of the value creation process, but are themselves trying to extract maximum value out of this system.

Second, there are customers, including individuals, corporates, institutions, or even travel agents and travel sites. They are trying to push our price down and capture more of the surplus for themselves.

Third, there are rivals, namely, those who provide a similar service, which is other airlines. Our company's price itself is set by considering a number of factors, including the extent of competitive pressure.

Fourth, producers of alternate products who can substitute us. In this case, this would include other modes of transport such as rail or road or other modes of communication such as videoconferencing. Anyone who meets the same customer needs, even in a different way, puts a cap on industry profitability.

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The fifth set of actors are potential new players from other industries or other markets who may enter and change the basis of competition or rivalry in our industry. These are the key actors in Porter's framework. They create pressures. Porter calls them forces, forces that can effectively make or break an industry.

Industry structure is a great tool for understanding the dynamics of competition. Each of these five forces has a clear, direct and predictable relationship to industry profitability. The general rule is the more powerful the force, the more pressure it will put on prices, or cost, or both and therefore, drive the attractiveness of the industry down.

Summarizing, industry structure and the resultant forces strongly influence how the total value created in an industry is distributed between the key players, customers, suppliers, substitutes, potential new entrants and complements.

Sixth, industry complements, that is producers of products or services that increase the value creation and capture opportunities for industry rivals. In other words, both suppliers and buyers prefer to deal with an industry which has more complements.

Finally, actions by the government also influence all these actors in the industry. Together, they form the industry structure, as explained by Porter.

So here is a question for you to reflect on. What are the key questions that you as a student of strategy should answer when you are doing an industry analysis?

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