Contents

1. What is Business Strategy and why do we study it?

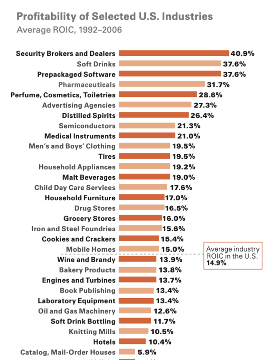
- The purpose of studying business strategy is to try to understand a very important question "why do some companies make money and others do not?"
- Why is this important?
- Because as you go through your career you have to think about how you are going to invest your time. If you are in startup land you'll be tasked with figuring out where to put your energy and effort.
- The purpose of business strategy, for this course, is to try to predict if you think a company will be successful.
- Maybe even more importantly you will be exposed to the tools and language around business strategy so that you can have conversations with other people about how they frame profitability and success.
- For public companies you have found that they outline their risk factors, describe their financial position in their financial docs, but for private companies you have to do the leg work yourself.

2. A brief history of biz-strategy

- Traditional Economic theory says that competition is the driver of profits. Limited competition means more profitability.
- However, there are tons of examples where this breaks.
- In real life we see:
  (1) Plenty of examples with sustainable, long-term, profit (soft drinks).

(2) Plenty of examples with very few competitors, but zero profit (Airlines and Hotels).
(3) Plenty of examples with lots of competitions and tons of profit (Financial Services).

- In the 50's and 60's (the beginning of business strategy as we know it now), there was a lot of work on "execution" as a driver of asymmetric profits.
  - The notion of execution is that internal performance is the most important driver of profit within a firm.
  - When studying execution, you often look into things like "organization structure", internal resource allocation, allocation evaluation methodologies and other "internal" aspects of the firm.
  - The goal at the time was to align the firm with the external business environment and, by doing that, you could achieve some business success.
  - The conclusion of this is that, within an industry you would have high performers and low performers and the profitability was a function of their internal execution.
- However, lets look at this chart which shows profitability by industry:



- This is a big blow to the notion that "execution" is the key driver of profitability. Why? Because This is at the *industry*, not company level. It seems far-fetched to believe that all companies within an industry "execute" well.
- This is also a bit of a blow to modern economics – if we believe the basics of supply/demand then any industry with significant reoccurring profitability should have more companies enter the space in order to drive the profit toward zero.
- In other words, profits are not transitory and are not consumed by competition itself.
- From the chart we can see that this does *not* happen.

- So if execution is not the driver of profitability and our predictions from economics don't work, then what is the driver of profitability?

3. Modern Biz Strat: 1980 forward

- In 1979 Porter wrote a very famous paper saying that the prime driver of profitability *in an industry* was not any of the above, but instead the result of specific forces which shape industries.
- Porter called this the Five Forces model
- Note that he isn't saying that execution doesn't matter, but that the execution sits in a larger competitive framework.
- Porter's key insight was that to explain the differences in profitability we have to re-define competition to include forces external to the specific industry in question.
  - Specifically it isn't just companies trying to provide a good or service in isolation, but against a larger competitive environment.
  - That larger competitive environment works in a number of ways to define the profitability of a specific *industry*.
- Since Porter's original article other analysts have added additional factors, but we will ignore them for this course as they are secondary to the five primal forces listed here.

4. The value chain and willingness to pay

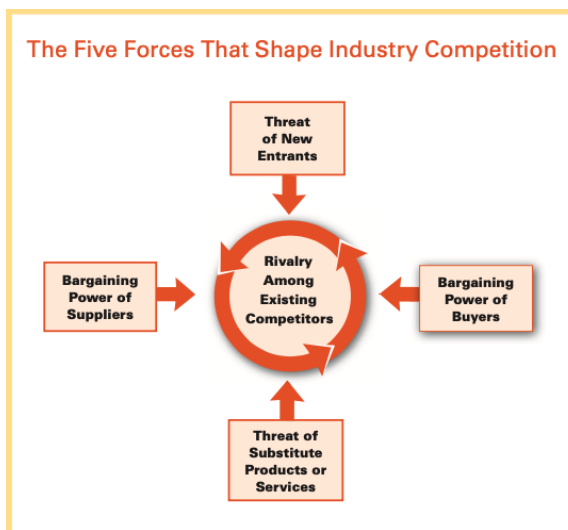
- An important way to conceptualize Porter's forces is by considering the notion of a *value chain* and a customer's *willingness to pay*.
- Start by looking at the customer and recognize that they have a "willingness to pay" for a specific good. Say, for example, a bottle of Coke for $2.
- An important observation is that the willingness to pay, while affected by some of the factors that we will talk about, is *static* and doesn't change.
- If the cost of the soda is above $2 then there will be no customers. This therefore represents a maximum amount of revenue that can be generated from the product.
- The question then becomes – if the cost of a soda is $2, how does the profit associated with that $2 get distributed among all of the companies that create that bottle of soda?
- For soda that means:
  1. Plastic Producer for the bottle
  2. Flavor/Spice providers who create the taste of the drink
  3. Coca-Cola who operates the machines which combine the above to make syrup
  4. Regional Bottlers who combine the syrup with water and CO2 as well as bottle the beverage.

(5) Distributors who sell the soda to stores
(6) The stores themselves who sell the soda

- For this value chain – who gets to the keep the majority of the profit? Obviously Coca-Cola.
- What Porter attempts to answer is *why* does Coca-Cola keep the profit on this value chain?

5. Vertical vs. Horizontal Integration

- An important concept for today is **integration**: where one company takes over another.
- Two types: horizontal and vertical. Funny enough, the distinction between them is defined via the value chain.
- **Horizontal** integration, which is when one company purchases another at the same stage of the value chain. For example if a company which makes bottles Coca-Cola purchases another company that makes bottles.
- **Vertical** Integration: when one company purchases another which is *adjacent* to it in the value chain – either above or below it.
- **Backward** Integration: When a company purchases one of its suppliers. This is a type of vertical integration.
- Examples:
  - Meta/FB purchasing Instagram
  - Google/Alphabet purchasing Motorola



6. Rivalry Among Existing Competitors

- Higher competition between existing firms results in lower profitability of those firms.
- Not always a function of the number of firms. It's possible to have very strong competition with only a few firms.
- Two important dimensions of Competition:
  (1) Intensity
  (2) What effects Intensity:
    - Numerous, equal sized competitors
    - Slow industry growth
    - Exit Barriers are High (better to lose a little bit of money then lose a lot selling your factory)

  (3) Type of competition:
    (a) Price: The worst for profitability because it erodes all power that the seller has.
    (b) Services / Features: Less bad because you can differentiate and possibly break up the market place to keep rents in place (think Toyota/Lexus)
- In software technology this is usually not the primary type of competition. It's not that common to have products which are substitutes enough for there to be a traditional competition.
- In hardware it is way more common, but companies try their best to avoid direct price competition (think about buying a mac vs. buying a PC).

7. Bargaining Power of Suppliers

- **The more powerful the supplier, the more of the value they can capture for themselves.**
- Why?
- Example: Microsoft Windows vs. PC Makers (Toshiba, Acer, HP)
- What makes a Supplier powerful?
  (1) Relative Concentration (the more concentrated = the more powerful)
  (2) Supplier Profit Dependence:
    - Does the supplier have other profit lines?
    - Does the supplier require this business to purchase from it?

  (3) Switching costs when changing suppliers? (Salesforce)
    - How standard are components? (AWS vs. GCP vs. AZURE)
    - How differentiated are components? (Drug companies)
    - Are there substitutes? (Pilots Union example)

(4) Threat of vertical integration (Supplier can threaten to move into the space).

- Example: Cloud infrastructure vs. Tech companies
  - If I'm a tech company how do I make this decision? Build vs. Buy?
  - Dropbox (build)
  - Facebook (buy then moved to build)
  - Google (build)
- Example Lyft in 2018: Spent roughly $80MM on AWS and Provided 600MM rides: AWS got $.13 cents per ride!

8. Power of Buyers

- Generally the opposite of the Power of Sellers
- The general pathway is that as buyer power goes up that leads to prices decreasing, which leads to decreased profits.
- They can also demand quality and service that can drive down profits.
- What makes a buyer powerful:
  (1) Relative concentration. As the number of sellers relative to buyers increases this moves power to the buyer.
  (2) If producing the good has a high fixed and low marginal cost this increases the buyers power.
  (3) Product standardization: higher standardization = lower profitability
  (4) Buyers can easily switch between suppliers
  (5) Package size relatively large.
  (6) Credible threat of vertical integration.
  (7) Buyers are price sensitive:
    - Product are significant fraction of their costs (likely to shop around)
    - Buyers are another low profit industry
    - Quality isn't that important
  (8) **Important caveat:** Intermediate companies in the value chain that can influence downstream behavior can claw back quite a bit of power (Best buy advertising).

9. Threat of Substitutes

- A *Substitute* provides the same or similar function as an industry's product by a different means. (Zoom for in-person meetings)
- Substitution can occur in multiple ways: directly, such as the above, but also in slightly less direct ways: People choosing to use Electric Vehicles and no longer purchasing gas.

- Substitutes are hard to analyze because they are context specific / Intention matters.

  Zoom is a replacement for Travel for Business meetings, but not so much for family reunions or weddings.
- Note that the "threat" is the most important thing, not the actual use. The threat of substitutes acts to convey power to the buyer – they can always choose the substitute.
- The threat of a substitute is high when:
  - Cost of switching low (zoom vs. google meet vs. facetime)
  - Value of substitute is competitive to current product.

10. Threat of New Entrant

- Provides a hard cap on the profitability of a firm. Why? If the profitability increases above the cost of entry then someone will enter in order to gain profits.
- *Barriers to entry* prevent new entrants:
  1. Supply-side economics of scale: making more of something drives down the per-unit cost.
  2. Demand-side scale: Network effects (buyers also trust larger companies) "No one ever got fired with buying from IBM"
  3. Customer switching cost
  4. Capital requirements (weak effect)
  5. Incumbency Advantage: proprietary technology, experience, understanding of the industry, data on how things work, established brand
  6. Unequal access to distribution channels: Supermarket shelf space.
  7. Government policy effect.
- Expected Retaliation. If potential entrants believe they will be retaliated against (e.g. price competition) they are less likely to go into the industry.

11. Other stuff

- Industry Growth Rate: Growth help mute competition (good), but also increases the likelihood of new entrants and the power of suppliers. It's not obvious that it is a positive opportunity.
- Government: I like to think about this as the environment that the rest of these forces lie in. Specific policies can tilt the competitive landscape in different ways, but it's not a direct force in the same way that the competitive forces above are.
- Technology and Innovation:
- Complementary products and services: Can push things around unexpectedly.

12. Transportation Network Companies (TNC)

- What is a TNC? TNC is the umbrella term for XXX-share companies (ride, scoter, bike, etc.) which provide decentralized mobility via apps and networks.
- Examples include Lyft / Uber
- Threat of new entrants (Nick say Low: surprisingly large capital, economics of scale and no known profitability to attract investment)
- Substitutes (Nick says High: Taxi, Bikes, Cars, Walk, Scooter)
- Power of Suppliers:
  - Car-makers: None
  - AWS/Cloud: Some, but not important
  - Labor (Drivers): Medium (switching costs are low, but alternatives are limited)
  - Engineers: Medium
- Buyer power: (Nick says High due to easy substitutes)
- Rivalry: (Nick says High – price competition with Lyft "the good one")