

# Good Business Run Wisely

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A newsletter to help you Maximize Value Creation in your business

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## Quote of the Month

"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."

— Warren Buffet

## Analyzing the Attractiveness of an Industry: *Porter's Five Forces Framework*

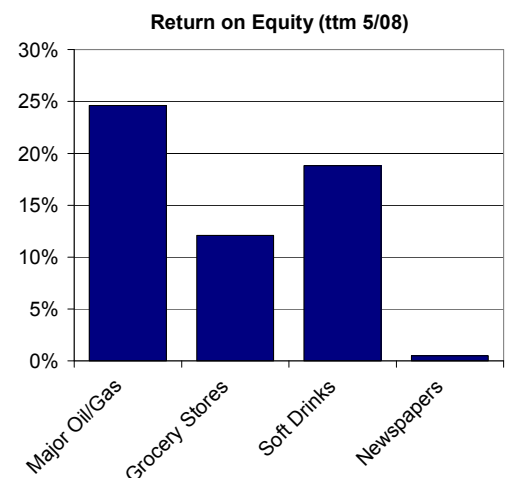
Some industries are more attractive than others, and understanding the attractiveness of an industry is essential before deciding to start or expand a business, invest in a business, or acquire a business. For as Buffet so wisely explained, it doesn't matter how smart you are, how great your product, or how wonderful your customer service will be—if you go into an unattractive industry your chances of survival are slim.

Industry attractiveness is largely the result of five "forces" which act upon a business:

1. Power of **Suppliers** relative to the industry
2. Power of **Buyers** relative to the industry
3. Threat of **New Entrants** into the industry
4. Availability of **Substitutes** to the industry
5. **Rivalry** among firms already in the industry

Pulling some basic data gives a snapshot of relative industry attractiveness, using Return on Equity (ROE) as the measurement. This data shows that the large, vertically-integrated oil companies seem to be in an attractive industry. Analyzing the industry using the Five Forces framework we find:

1. **Suppliers** have moderate power
2. **Buyers** have very little power (especially over the short run)
3. It is difficult for **New Entrants** due to government regulations and enormous capital required
4. True **Substitutes** are nil
5. There is little **Rivalry** because there are now only five majors in the U.S.: ExxonMobil, ConocoPhillips, BP-Amoco, Chevron (Texaco), & RD Shell.



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In contrast, grocery stores are not as attractive an industry because major suppliers (i.e. Procter & Gamble) have significant power, buyers can switch between stores easily, including department stores, supercenters and restaurants; plus there is an intense rivalry between stores. And although soft drink companies have higher gross profits than the oil companies (Pepsi=55%, Coke=64% vs. Exxon=42%, BP=29%), the amount of rivalry in the industry is fierce, killing profits and ensuring new entrants do not survive. Newspapers are dead because buyers have all the power and the substitutes are more attractive.

To avoid entering an industry with bad economics, read the full article on [Porter's Five Forces](#).

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## Growth vs. Profitability

Executives and investment analysts are constantly focused on growth: Growing market share, expanding, and mergers and acquisitions (M&A) are exciting. And being able to say that your company is the largest in its field or has been growing at a high rate is impressive. But while there is a positive correlation between market share and profitability, focusing *primarily* on growth comes at the expense of profits.

Last year J. Scott Armstrong, a marketing professor at the prestigious Wharton School of business, illustrated this point in a paper published in the [International Journal of Business](#). The reason profits fall, he found, is that executives lose focus of what is best for the company because they start focusing on their position relative to competitors instead.

Armstrong and his co-authors backed their findings with historical evidence that showed companies such as Kroger and Exxon, which focused on profit rather than competition, had higher return on investment (ROI) numbers than did their competitors A&P and Amoco.

More interesting were the array of laboratory studies. In one, MBA students played a simulation game in which they were told they could each earn a profit of \$20 if they cooperated. Instead they all proceeded to undercut each other on price in an attempt to win market share. The average profit was \$7.19—35% of the “cooperative” profit.

Another study paired seasoned executives in a similar game, but this time they controlled advertising budgets rather than price. Initially, shown only their own firm's advertising budgets, the players rationally maximized profits. But when the executives were shown their competitors budgets, they ratcheted up their advertising budgets in relation to competitors and both companies' profits fell.

These findings are not shocking, but they do emphasize that the goal is Maximizing Value Creation, not becoming the biggest in the market. Focusing on net profits rather than market share, that's **Maximizing Value Creation through Good Business Run Wisely**. Δ

Armstrong's paper can be read [here](#).