

XP Actuarial SDM Exam Study Manual Introduction

Hey students, this is Steve. I've been working with SDM students for about 5 years now. Here are a few introductory comments to help you with getting SDM.

First, be sure you have watched the introductory videos on the portal:

- The reality of SDM
- How XP helps on SDM
- If you previously failed this exam, watch the video on using prior exams BEFORE you look at the SOA solutions for last sitting

OK, so having watched those videos, you should understand now that SDM is a bigger challenge than the other finance track exams because you are competing against almost exclusively students that have already passed 2 written exams. You now have to get into the top 40% of the *really* good students. But be clear, you can do this!

Second, to reiterate and slightly expand on what was covered in the above videos, we have found the following things empirically make the biggest differences:

- 1) **Diligent studying** – use your diligent study approach and great time management skills to learn the material, become really familiar with the case study, and stay on schedule.
- 2) **Have more time for additional questions** – this exam challenges you to deeply apply the material in different situations and in different ways. To close the gaps between your knowledge and your ability to apply it, we have XP Application Questions, practice exams, and the Business Dynamics Assignment to help you in addition to the past SOA questions.
- 3) **Develop “system 1” answering skills** – This is about closing the gaps between your answers and how the graders will score them. The big trick is doing enough practice so those answering skills improvements are automatic or “system 1”. There are answering skills videos, specific XP practice exams that will test these skills well, and very detailed video feedback from me to help you make sure you are scoring maximum points on HOW you answer SDM questions.

One caveat to (1) above: if you tend to spend almost all of the last two weeks of your studying on just memorization, you should definitely consider using some of the other memory tools before then – e.g. the XP key point cards or audio cards. I have found students need time to do BOTH memory work AND a good amount of timed question practice over the final two weeks to properly prepare for how SDM tests you, so using some of those other tools can help you with having more time for practice in the final weeks, and not JUST memorization.

And one more point: a lot of the SDM material is really interesting. In fact, this exam is specifically designed to be like a **mini-MBA program**, so you will learn a lot of useful stuff for your future career.

A few important details to note:

- The XP study manual is NOT a replacement for the source material – Instead, it is a more condensed summary and it contains a number of intuitive explanations of the material. *You will need the source material.*
- **If you want, I can let you know the most important textbooks to have** (for sure Data, Models, and Decision & the Business Dynamics books are important as I have solutions to selected problems from those books). **IMPORTANT NOTE:** *All of the SOA study notes are available online (I include a list of links on the portal).*
- About every 2 or 3 weeks I send out a short message to students to help guide them along the way – be sure to watch your email for those (my email is steve.scoles@xpactuarial.com)
- **Most of the important tools** – XP Application questions, Business Dynamics assignment, and XP Practice exams **are released in the final 6 to 7 weeks as we have constantly found that students need to do those closer to the exam.**
- The two XP case study tools are released after the case study is updated – usually around mid to late February of each year

A few first steps you can do:

- Tell a friend or spouse that this exam will take a full effort for you and have them encourage you and support you along the way to help keep you on track.
- Build some time into your plan for question practice, the Business Dynamics Assignment, case analysis, and answering skills over the last 4 to 6 weeks.
- Plan to attempt 3 or 4 past SDM questions at least 6 weeks out so you see how you are tested on SDM for what you are studying (the XP “Past Relevant Exam Questions” lists a few to try)
- Do a short review of the SDM-version of the case study early on (note: the new version of the case comes out in February of each year)
 - E.g. compare it to the CFE version to see how the SDM version is different
 - This is an important step before getting into lots of SOA and XP questions for SDM
- **Set a goal** of submitting an exam practice in the last 10 to 6 days before the exam for feedback. (And feel free at any time to send me an example of one of your answers to a past SOA question to give you some quick objective feedback on your answering skills.)

As always, feel free to reach out with questions or any ask advice. Students are always really surprised by how much I am willing to help them directly in getting this exam.

XP tools aside from the study manual that are all available to you on the portal:

Key point flash cards – these are the key points from the study manual – very efficient for doing a 20 to 30 minute weekly review of the material to keep on top of your learning.

Audio Cards – flash cards that you can listen too. If these are easy for you to use, you may want to try them as quite a few students find them helpful as a supplement to their regular studying. E.g. listen to them on a walk or while doing chores.

Flash cards – cover the entire syllabus – there are both pdf and ANKI flash cards.

Seminar Videos – I touch on key points on each topic in the syllabus and relate them to the case study and/or real life situations. I also sometimes solve example questions.

Practice Recall Questions – these are memory/recall questions that cover the entire syllabus

Case Videos – videos on specific questions on the case study companies

Case Study Checklist – about 100 references in the case study that connect with specific syllabus material. This is only intended as an intermediate step before doing SOA and XP questions

Application Questions – these are a combination of medium and medium-hard critical-thinking questions – RELEASED about 6 weeks prior to the exam (as we found that students need to do them closer to the exam to properly PEAK for a critical-thinking exam).

Assignments – we have a Business Dynamics Assignment as we have found students need a lot of practice on this material. Many students have found this to be super-helpful.

Practice Exams – 4 practice exams that simulate the real thing. They have extensive answer commentary that show the typical errors students make with SDM-style questions.

Answering Skills videos – After reviewing hundreds of student’s practices on SDM specifically, we found a number of areas where students unknowingly and painfully lose marks. The key is not only knowing these mistakes, but **practicing enough so they are system 1** under exam time limits. (You’ll learn about system 1 in Objective 5 of the syllabus!)

Personal Video Feedback from the instructor – using past SOA exam questions and XP practice exams. I will give you OBJECTIVE & detailed feedback on HOW you are answering. Students are consistently surprised at what I show them in their feedback. You need to get feedback from me on something if you want a free re-use of the study material (but we will work hard to ensure you don’t need that re-use!)

The items in **RED** are released over the final 4 to 8 weeks before the exam as we have found that students should be using them closer to the exam to properly PEAK for exam day. **Basically your goal is to learn the material reasonably well** and then you have the tools in RED to really help push you to be able to answer tough critical-thinking SDM questions really well on the exam.

Strategic Management: Competitiveness and Globalization

Chapter 1

Key Points:

- **Competitive Advantage** – when a firm implements a strategy that creates value for customers (or reduces the firms costs) that other firms can't or find to costly to copy
- **Above average returns** (also called economic profits in other readings) are returns in excess of other investments with similar risk
- **Industrial Organization (I/O) Model:** states that a firm's performance is only attributable to its external market it operates in
- **Resource Based Model:** firm performance depends on its external environment but more so on its resources and capabilities (i.e. internal strengths & weaknesses)
- I/O and Resource-based models reflect the potential strategies that could be used given different external environments or strengths of the firm
- Other topics: vision, mission, key firm stakeholders; introduces Five Forces analysis

Important Instructor comments about the Strategic Management textbook

The Strategic Management text chapters covered on the SDM syllabus for Objective 1 are mainly about how a company:

- Analyzes its competitive environment/markets
- Analyzes its own internal strengths and weaknesses
- Given the first two items what strategies make the most sense for the company

Where students often struggle with this book is that they don't apply the concepts to companies they know or don't get into the detail of what is important and what's not in different companies/situations/industries

As a first step, take one or two companies that you know well and try to apply the concepts. For example, take Apple. Apple uses a **differentiation strategy** by having a powerful brand and constantly innovating to bring new features and app capabilities to its products. Because of this strategy, many customers are **willing to pay higher prices** for Apple products, allowing Apple to **earn above average returns** on its investments relative to its competitors.

At the same time, many competitors, such as Samsung, have competed aggressively against Apple and have been able to take market share from Apple. Furthermore Apple needs to be concerned about political actions such as foreign governments placing tariffs on its products. These are examples of Apple needing to understand its **external environment in determining the best strategies**

Continuing this example, Samsung, in its efforts to defeat Apple, sometimes **uses first mover strategies** such as when it was the first to introduce larger screen smartphones. This was risky as it had not been attempted before and thus the results were less predictable. However, once large phones were recognized as a useful feature, Samsung became recognized as an innovative company as well and was able to strengthen its brand and garner many loyal customers

By taking a couple of companies you know, you can start to get a better understanding of how to apply many of these strategy concepts so the concepts become less murky.

Later on, there will be many opportunities to apply these concepts to the case study through the case study assignment and checklist. Also, the XP Application questions have many questions relating the SM concepts to the case study. And finally, the final tough XP practice exams have several tough questions to push your ability to apply these concepts really well to very specific situations.

Why do you need a deep understanding of how to apply these concepts in detailed situations? Because that is specifically how you will be tested on this material. The exam graders are always noting that students **lose a lot of marks** because their answers were **not specific to the situation given**. So if all you have done is memorized the lists, you will not do well on this exam! You also need to be able to apply the information deeply ... and accurately.

Let's take a look at **learning outcomes** for Objective 1 – e.g. **assess growth strategies under different business situations and market opportunities**.

OK, so here is a possible exam question related to the case study: Blue Jay Air has expanded into a new market and is now facing a new aggressive discount airline competitor. Explain how Blue Jay should adjust its strategy to this new market and competitive threat. Justify your answer

So, you need to get to a level where you can make assessments (i.e. draw conclusions) as to what a company should do a specific situation.

Active Study Tip: Write down a list of a couple of companies you are familiar with and make notes on those companies as a way to apply the concepts in this whole book!

Introduction

- **Strategic Competitiveness:** achieved when a firm successfully formulates and implements a value-creating strategy
- **Strategy:** integrated and coordinated set of commitments and actions designed to exploit core competencies and gain competitive advantages
- Firms make choices between competing alternatives when setting strategy
- Strategy dictates what a firm will and will not do in the marketplace
- Successful companies clearly understand their market and customers – they also innovate
- **Competitive Advantage:** occurs when an implemented strategy creates superior value for customers that its competitors are unable to duplicate/find too costly to imitate
- **Risk:** the investor's uncertainty about the economic gains/losses that will result from an investment
- Managing risk reduces investor uncertainty about performance
- Returns can be measured with accounting ratios (Return on Equity, Return on Assets, etc.) or with Stock Market Returns (percentage return on the firm's stock price over a period)
- Smaller firms use the rate of growth as a measure of return (new ventures may not generate net income as they are aggressively spending on growth)

- **Above-Average Returns:** returns in excess of what an investor expects to earn from other investments with a similar amount of risk
- **Average Returns:** returns equal to what an investor expects to earn from other investments with a similar amount of risk

Strategic Management Process:

- The full set of commitments, decisions, actions required for a firm to achieve strategic competitiveness and earn above-average returns
- Involves:
 - Analysis: analyze external environment/internal organization, determine resources, capabilities, core competencies
 - Strategy: includes strategy formulation and implementation
 - Performance

The Competitive Landscape

- Financial capital is scarce and markets are increasingly volatile – pace of change is increasing
- Managers need a mindset that is flexible, quick, innovative, integrative, and adapts to the ever evolving challenges that the company faces
- Effective use of strategic management reduces the likelihood of failure for firms
- Hyper-competition: term that captures the reality of the competitive landscape
- Hyper-competition results in a continuous instability and change
 - Drivers of Hyper-competition: Global Economy, Technology

1.1a The Global Economy

- **Global Economy:** an economy in which goods, services, people, skills, ideas move freely across geographic borders
- **Globalization:** the increasing economic interdependence among countries and their organizations across borders
- Globalization increases the range of opportunities that a firm has to choose from
- Global firms must take into account different cultures of different markets
- Global firms must also be aware of the complexity of their operations
- BRIC Countries: Brazil, Russia, India, China
- VISTA Countries: Vietnam, Indonesia, South Africa, Turkey, Argentina

Risks of Globalization:

- Firm may not know how to compete in new markets
- Firms may over diversify and their performance may suffer as a result

1.1b Technology and Technological Changes

- 3 Categories of Technology Related Trends/Conditions:
 - Technology Diffusion and Disruptive Technologies
 - Information Age
 - Increasing Knowledge Intensity

Technology Diffusion and Disruptive Technologies

- **Rate of Technology Diffusion:** the speed at which new technologies become available/used
- Perpetual Innovation: the rapid process by which new information-intensive technologies replace older technology
- There is a competitive premium on being able to keep up with innovation – speed to market with innovative products can be the primary source of competitive advantage
- Many firms do not apply for patents any more (electronics industry) – stops competitors from gaining information that is contained in the patent
- Patents still useful for Pharmaceutical industry
- **Disruptive Technology:** technology that destroys the value of an existing technology and creates new markets

The Information Age

- There has been large changes in information technology in recent years
- Ability to effectively/efficiently access information is an important competitive advantage
- Information technology costs are now inexpensive
- The internet contributes to Hyper-competition – allows access to information globally

Increasing Knowledge Intensity

- Knowledge is one of the most important resources (intangible resources) for any firm
- Important for firms to invest in knowledge – training/acquiring knowledge
- Need to integrate the firms knowledge into the entire organization
- **Strategic Flexibility:** the set of capabilities used to respond to various demands/opportunities that exist in an uncertain/dynamic competitive environment
- Firms need to develop their ability to learn – continuous learning is essential to develop

1-2 The I/O Model of Above-Average Returns

- **I/O:** Industrial Organization
- Focuses on the effect the external environment has on the firms strategic actions
- Model states that the external industry/segment that the firm operates in has a stronger influence on performance than manager internal choices
- Firm performance depends on:
 - Economies of scale, barriers to market entry, diversification, product differentiation, degree of concentration of firms in industry, market frictions

- Model has 4 underlying assumptions:
 - External environment imposes pressures/constraints that determine the strategies that produce above-average returns
 - Firms competing in the same industry have similar strategies/resources available
 - Resources are highly mobile across firms (people can move firms, etc.), resource differences between firms are short-lived
 - Decision makers are rational/act in the firm’s best interest, maximize profit
- I/O model forces firms to find the best industry for it to compete in
- Firm performance can increase if they operate in the industry with the highest profit potential
- **Five Forces Model:** bargaining power of suppliers, power of buyers, competitive rivalry among firms, product substitutes, potential entrant of new players
 - Use the five forces model to identify the attractiveness of an industry, best position to take given industry characteristics
 - Firms can succeed by:
 - Producing standardized goods/services at lower costs
 - Producing differentiated goods/services that customers are willing to pay a premium for

Instructor comment: Five forces analysis can be done for an overall industry OR from the perspective of a single company ... or a single business within a company

- For example, you could do a five forces analysis on the Online Search industry; or you could do it on Google’s online search capabilities versus the rest of the industry
- Or you could even look at You-tube (a subsidiary of Google) versus the rest of the entertainment industry – i.e. You-tube is competing against things like Netflix, regular TV, and video games for your entertainment time
- Five forces analysis is covered in more depth in Chapters 2 & 4

The I/O Model of Above-Average Returns

Study the external environment (industry environment)	External Environment: <ul style="list-style-type: none"> • General environment • Industry environment • Competitor environment
Locate an industry with high potential for above-average returns	Attractive Industry: <ul style="list-style-type: none"> • Industry with above-average returns
Identify the strategy needed for above-average returns	Strategy Formulation: <ul style="list-style-type: none"> • Select a strategy that produces above-average returns
Develop/acquire assets/skills needed to implement strategy	Assets/Skills: <ul style="list-style-type: none"> • Need the assets/skills required to implement the strategy
Use the firm’s strengths to implement strategy	Strategy Implementation: <ul style="list-style-type: none"> • Implement the strategy effectively
Superior Returns: earn above-average returns	

- Research shows that external factors are not the only contributors to above-average returns

1-3 The Resource-Based Model of Above-Average Returns

- Assumes each organization is a collection of unique resources/capabilities
- The uniqueness of the firm’s resources/capabilities is the basis of the firm’s strategy and ability to earn above-average returns
- **Resources:** inputs into the firm’s production process (Ex: capital equipment, skills of employees, patents, etc.)
 - Classified into 3 categories:
 - Physical, human, organizational capital
 - Can be either tangible or intangible
- **Capability:** the capacity for a set of resources to perform a task/activity in an integrative manner
- **Core Competencies:** resources/capabilities that are the competitive advantage for a firm
- Differences between firms are due to different resources/capabilities not the industry characteristics
- **Resource/capabilities generate a competitive advantage if they are:**
 - **Valuable, rare, costly to imitate, non-substitutable**
- Difficult to achieve a competitive advantage on resources alone

1. Identify the firm’s resources, study strengths and weaknesses of firm	Resources
2. Determine firm’s capabilities	Capability
3. Determine how the firm’s resources/capabilities can generate a competitive advantage	Competitive Advantage
4. Choose an attractive industry	Attractive Industry
5. Select a strategy that best suits the firm’s resources/capabilities	Strategy/Implementation

1-4 Vision and Mission

- **Vision:** picture of what the firms wants to be, what it wants to achieve, states the firms direction and where it wants to be in the years to come
- **Mission:** specifies the business or businesses in which the firm will compete in, the customers it will serve
- Strong tie in from multiple stakeholders creates a more powerful Vision/Mission for the firm

1-5 Stakeholders

- **Stakeholders:** the individuals, groups, organizations who affect the firm’s vision/mission, are affected by the firm’s strategy, have enforceable claims on the firm’s performance
- **Stakeholders:** people who are affected by a firm’s performance and who have a claim on its performance
- Stakeholder strategy – e.g. Apple built an app ecosystem with its app supplier stakeholders allowing it to overcome the previous dominant smartphone – which was BlackBerry

1.5a Classification of Stakeholders

- Firm must identify all stakeholders, prioritize the stakeholders in case all cannot be satisfied

Capital Market Stakeholders

- Shareholders, major suppliers of capital (e.g. banks)
- Expect the firm to preserve/enhance the capital that was provided to the firm
- Return expected is tied to the expected amount of risk (higher risk = higher return)
- Large shareholders put a large influence on management
- The response to capital market stakeholders demands depends on the power that they influence on the firm

Product Market Stakeholders

- Customers, suppliers, host communities, unions
- Customers want reliable products at the lowest cost possible, suppliers want loyal customers will to pay the highest prices possible for products
- Customers more important than suppliers as without customers there is no need for suppliers
- Host Communities: national/state/province/local government entities

Organizational Stakeholders

- Employees, managers, non-managers
- Employees want dynamic, stimulating, rewarding work, with opportunities to learn/grow

Instructor comment: A basic takeaway here is know the stakeholders and what matters to them. You could get an exam question that asks you to identify concerns of stakeholders in a specific situation, so you should have a quick & basic understanding of what they are and what they care about

1-6 Strategic Leaders

- **Strategic Leader:** people located in different areas/levels of the firm using the strategic management process to select strategic actions that help the firm achieve its vision/mission
- Strategic leaders are not just the CEOs, good CEOs delegate strategic decisions throughout the firm
- **Organizational Culture:** the complex set of ideologies, symbols, core values that are shared throughout the firm, that influence how the firm conducts business

1.6a The Work of Effective Strategic Leaders

- Top leaders are chosen based on the following:
 - Capabilities, knowledge gained over time, hard work, wanting the firm to succeed
- Management teams with high levels of human capital/management skills/cognitive abilities make better strategic decisions

- Strategic leaders need to be innovative thinkers, promote innovation, seek both new knowledge and incremental improvement of current knowledge, have a global mindset

1-7 Strategic Management Process

- Rational approach firms use to achieve above-average returns/strategic competitiveness
- A firm's performance is directly related to how well it can achieve strategic competitiveness and earn above-average returns

Strategic Management: Competitiveness and Globalization

Chapter 2: The External Environment

Key Points:

- **Five Forces:**-threat of new entrants, power of suppliers, power of buyers, threat of substitute products, intensity of rivalry
- **Barriers to Entry:** Economies of scale, product differentiation, capital requirements, switching costs, access to distribution channels, proprietary technology, and government policies
- **Switching Costs:** one-time costs customers incur when they buy from a different supplier - for example the time required to switch your spreadsheet files from Excel to a different product
- **Environment Segments:** demographic, economic, political/legal, sociocultural, technological, global, physical environment
- **Power of buyers** – Customers are powerful when: Can purchase a large portion of an industry’s total output, Sales of the product account for a significant portion of the sellers revenues, Low switching costs, Industry products are standardized, or Buyers could integrate backward – become a competitor to the firm

Instructor Comments:

This chapter has a lot of general concepts (e.g. general ideas around “scanning” the environment). But there are some important concepts that you should focus on to really dig in to and apply.

- **Five forces analysis:** Can you do that for an individual company or industry?
- Each of the five forces is important unto itself – it’s common for students to think of “doing a five forces analysis”, **but could you do a very deep analysis just on “barriers of entry” or “power of suppliers”?**
- For opportunities & threats in section 2.2, think about what those are for the company you work for
- There are XP Application Questions that will help you develop your ability to do five forces analysis

Active Study Tip: Take one company you know and focus on each of the five forces – this is a good thing to do with a study friend if possible. This tends to be a bit hard when you first do it, but it will come easier with practice

- For example, look at Apple – do a five forces analysis of it and its industry
- One thing that will quickly jump out at you is exactly what is Apple’s industry? – Smart phones, entertainment, computers ... -> you need to think about what industry you need to analyze!
 - From the textbook, an industry is a group of firms producing products that are close substitutes
 - BUT you need to think more broadly about current and potential competitors
- As a side note, Warren Buffett purchased a large amount of stock in Apple – he said he did it because Apple users had “**high switching costs**”

Active Study Tip: in addition to personal examples, find one or two examples in the source reading that resonate with you to understand a concept – this can be done throughout the Strategic Management textbook.

2-1 The General, Industry and Competitor Environments

- **General Environment:** the broader society which influences the firm
- Grouped into 7 segments:
 - Demographic, economic, political/legal, sociocultural, technological, global, physical
- **Industry Environment:** set of factors that directly influences a firm
- Includes (Porter's 5 Forces):
 - Threat of new entrants
 - Power of Suppliers
 - Power of Buyers
 - Threat of Substitute Products
 - Intensity of rivalry (competition) among firms
- **Competitor Analysis:** how a firm gathers/interprets information about its competitors
- **Competitor Environment:** understanding the main competitors in the market

2-2 External Environmental Analysis

- External Environmental Analysis:
 - Scanning, monitoring, forecasting, assessing
- **Opportunity:** a condition that if exploited helps the company reach a strategic competitiveness
- **Threat:** a condition that hinders the company's efforts towards achieving a strategic competitiveness
- Sources used to conduct External Environmental Analysis:
 - Trade publications, newspapers, business publications, academic research, trade shows, suppliers, customers, public sector employees, internet

2-2a Scanning

- The study of all segments of the general environment
- Helps to understand trends in the general environment – help predict implications
- Firms identify early warning signals of potential changes in the environment
- Internet provides many resources that can be used for scanning

2-2b Monitoring

- Observing the external environment to detect if trends that were spotted in scanning have started to unfold
- Need to identify important stakeholders and understand the firm's reputation among those stakeholders

2-2c Forecasting

- Developing projections of what may occur in the future – very challenging

2-2d Assessing

- Determine the timing/significance of the effects of environmental changes/trends
- Specify the implications of the results of scanning/monitoring/forecasting

2-3 Segments of the General Environment

2-3a The Demographic Segment

- Demographic Segment: includes population size, age structure, geographic distribution, ethnic mix, income distribution

2-3b The Economic Segment

- **Economic Environment:** the nature/direction of the economy in which a firm competes/may compete
- Firms seek to compete in relatively stable economies with strong growth potential

2-3c The Political/Legal Segment

- **Political/Legal Segment:** the area that includes law/regulation setting bodies, local governments, government agencies – between nations and between firms
- Concerned with how organizations attempt to influence governments
- Firms will develop a political strategy
- New regulations can have an effect on the firm – firms need to monitor these developments and take preventative action if needed

2-3d The Sociocultural Segment

- Concerned with society's attitudes/cultural values – these often drive demographic, economic, political/legal, and technological changes
- Firms need to scan/monitor/forecast/assess attitudes/cultural orientations
- Workforce in the US has shrunk, however, the percentage of female/minorities has increased – creates greater diversity and challenges – Different leadership styles

2-3e The Technological Segment

- Includes the institutions/activities involved in creating new knowledge and translating that knowledge into new outputs/products/processes/materials
- Vital for firms to study the technological segment
- Firms need to scan the environment to identify potential substitutes for technology currently in use – identify new emerging trends

2-3f The Global Segment

- Includes relevant new global markets, existing markets that are changing, important international political events, critical cultural/institutional characteristics
- Globalization creates opportunities to enter new markets and threats that new competitors from other economies may also enter their market
- Global-focusing: used by firms with moderate international exposure, increase international presence by focusing on global niche markets

2-3g The Physical Environment Segment

- Potential/actual changes in the physical environment/business practices that are intended to positively respond to/deal with changes
- Includes actions such as “sustainability” and “corporate social responsibility”
- **Sustainable Development:** the development that meets the needs of the present without compromising the ability of future generations to meet their own needs

2-4 Industry Environment Analysis

- Industry: a group of firms producing products that are close substitutes
- The industry’s characteristics influence a firm’s chosen strategies
- Importantly, firms must search more broadly to recognize current and potential competitors

Instructor comment: for example Netflix in North America views itself as competing against all forms of entertainment: movies, TV shows, AND video games

2-4a Threat of New Entrants

- New entrants can threaten the existing market share of firms
- More competitors in a market without new demand, lowers the returns in the segment
- New entrants want to gain a large market share so they force current providers to become more efficient/compete in new dimensions
- Threat of new entrants depends on two factors:
 - Barriers to entry
 - Retaliation expected from current industry participants

Barriers to Entry:

- **Economies of Scale:** derived from incremental efficiency improvements through experience, the cost of producing each unit declines as the quantity produced increases
- Firms may also gain competitive advantages with strategic alliances/joint ventures
- Product Differentiation: creating a product that is unique and which the customer views as unique, leads to customers that consistently purchase the firm’s products
- Capital Requirements: firms need resources to invest, capital needed for things like inventory, marketing, etc.
- **Switching Costs:** one-time costs customers incur when they buy from a different supplier

- Access to Distribution Channels
- Cost Disadvantages Independent of Scale: in some cases, established players have cost advantages that new entrants cannot duplicate (proprietary technology, favorable access to raw materials, etc.)
- Government Policy: governments can control the entry of new competitors into an existing market

Instructor comment: two examples of *switching costs*

- High switching costs – a long-time user with many critical files switching from using Microsoft Excel to a completely new spreadsheet software program – it would be very time-consuming to switch all of those files, therefore, they keep using Microsoft Excel
- Low switching costs – switching brands of plastic garbage bags – I have to buy new garbage bags and I just buy the ones that have the lowest price
- Switching costs is a good concept to have in your back pocket for and competitive analysis for the exam!

Expected Retaliation:

- If current established firms are swift/vigorous with a response to a new entrant – it makes new entry more difficult
- Finding niche markets not currently served/well served by established firms is one way to overcome this

2-4b Bargaining Power of Suppliers

- Suppliers can increase prices/reduce quality of products offered
- If a firm cannot recover the increase in supply cost from customers it reduces firm profitability
- Powerful supplier groups are:
 - Dominated by a few large suppliers, more concentrated than the market it sells to
 - Substitute products not available
 - Industry firms do not make up significant customers for suppliers
 - High switching costs for buyers
 - Threat that suppliers can “integrate forward” – become a competitor

2-4c Bargaining Power of Buyers

- Buyers want to purchase products at the lowest price possible – buyers want higher quality products, greater levels of service, lower prices
- Customers (buyers) are powerful when:
 - Can purchase a large portion of an industry’s total output
 - Sales of the product account for a significant portion of the sellers revenues
 - Low switching costs
 - Industry products are undifferentiated/standardized
 - Buyers could integrate backward – become a competitor to the firm

2-4d Threat of Substitute Products

- Threat of goods/services from an outside industry that perform a similar function as the product the industry produces
- Larger threat if customers have low switching costs, if the substitute product price is lower, quality is equal/greater

2-4e Intensity of Rivalry among Competitors

- Numerous or equally balanced competitors
- Slow industry growth – slow growth industries create more intensity among competitors
- High fixed costs or high storage costs – firms with high storage costs/perishable products have more incentive to reduce price to reduce built up inventories
- Lack of differentiation or low switching costs – if products are viewed as commodities, intensity of competition increases
- High strategic stakes
- High exit barriers – factors that make it hard for a firm to exit an industry even if not performing well

Instructor comment: Importantly, note that a Five Forces analysis can be done from a company's perspective or an overall industry perspective – you need to be careful as to what the question is asking you for

2-5 Interpreting Industry Analyses

- Analyzing the 5 forces allows a firm to determine if an industry is worthwhile entering
- Attractive industry has high entry barriers, low bargaining power of suppliers/buyers, few competitive threats from substitute products, and relatively moderate rivalry

2-6 Strategic Groups

- **Strategic Group:** a set of firms using similar strategies
- Competition between firms that belong to a strategic group is greater than that of firms that do not belong to a strategic group
- Strategic groups are useful for analyzing an industry's competitive structure

2-7 Competitor Analysis

- Focuses on each competitor that competes against the firm
- Looks to understand the competitors objectives, strategies, assumptions, capabilities
- Consists of 4 dimensions:
 - Future Objectives
 - Current Strategy

- Assumptions
- Capabilities
- **Competitor Intelligence:** the set of data/information the firm gathers to better understand/anticipate competitors
- **Complementors:** companies/networks of companies that sell goods/services that are compatible with the firm's goods/services, products that complement the firm's products

2-8 Ethical Considerations

- Firms must follow relevant laws/regulations, must abide by ethical guidelines
- Legal/ethical ways to obtain competitor information:
 - Publicly available data (court records, advertisements, annual reports, financial statements, etc.)
 - Attend trade fairs/conventions – obtain competitor brochures, attend presentations
- Some methods are legal but not necessarily ethical – need to consider the firm's image for some methods
- Firm's competitive actions/responses are influenced by the external environment
 - General, Industry and Competitor External Environments

Student Question

Factors that affect the intensity of firms' rivalries: high strategic stakes. What does strategic stake mean in this context? Why competitive rivalry is likely to be high when several competitors need to perform well in the market?

This one is one of the more fuzzy aspects of intensity of rivalry (as opposed to more concrete things like low differentiation or high fixed costs). I think a good example might be COVID vaccines. There are VERY high stakes a manufacture/drug company gets it right and does it quickly. Some vaccines, e.g. Astra Zeneca, has had more problems and has thus become less used in the world, whereas others have had very quick and successful uptake and have produced large profits for their manufacturers (e.g. Pfizer and Moderna). i.e. the stakes were very high to be successful early on in creating COVID vaccines and it meant a lot more or a lot less profit.

It's much more qualitative to say the stakes are high and is less likely to be useful in an exam question, whereas the other factors, such as low differentiation or high fixed costs, are easier to point to and support.