Part 2: BUSINESS ANALYSIS AND VALUATION TOOLS

Chapter 2:
Strategy Analysis

Discussion Questions

1. Julie, an accounting major, states: 'Strategy analysis seems to be an unnecessary detour in doing financial statement analysis. Why can't we just get straight to the accounting issues?' Explain to Julie why she may be wrong.

Strategy analysis enables the analyst to understand the underlying economics of the firm and the industry in which the firm competes. There are a number of benefits to developing this knowledge before performing any financial statement analysis.

1. *Strategy understanding* provides a context for evaluating a firm's choice of accounting policies and hence the information reflected in its financial statements. For example, accounting policies (such as revenue recognition and cost capitalisation) can differ across firms either because of differences in business economics or because of differences in management's financial reporting incentives. Only by understanding differences in firms' business strategies is it possible to assess how much to rely on a firm's accounting information.
2. *Strategy analysis* highlights the firm's profit drivers and major areas of risk. An analyst can then use this information to evaluate current firm performance and to assess the firm's likelihood of maintaining or changing this performance based on its business strategy.
3. *Strategy analysis* also makes it possible to understand a firm's financial policies and whether they make sense. As discussed later in the book, the firm's business economics is an important driver of its capital structure and dividend policy decisions.

In summary, understanding a firm's business, the factors that are critical to the success of that business, and its key risks is critical to effective financial statement analysis.

2. What are the critical drivers of industry profitability?

- **Rivalry Among Existing Firms:** The greater the degree of competition among firms in an industry, the lower average profitability is likely to be. The factors that influence existing firm rivalry are industry growth rate, concentration and balance of competitors, degree of differentiation and switching costs, scale/learning economies and the ratio of fixed to variable costs, and excess capacity and exit barriers.
- **Threat of New Entrants:** The threat of new entry can force firms to set prices to keep industry profits low. The threat of new entry can be mitigated by economies of scale, first mover advantages to incumbents, greater access to channels of distribution and existing customer relationships, and legal barriers to entry.
- **Threat of Substitute Products:** The threat of substitute products can force firms to set lower prices, reducing industry profitability. The importance of substitutes will depend on the price sensitivity of buyers and the degree of substitutability among the products.
- **Bargaining Power of Buyers:** The greater the bargaining power of buyers, the lower the industry's profitability. Bargaining power of buyers will be determined by the buyers' price sensitivity and their importance to the individual firm. As the volume of purchases of a single buyer increases, its bargaining power with the supplier increases.
- **Bargaining Power of Suppliers:** The greater the bargaining power of suppliers, the lower the industry's profitability. Suppliers' bargaining ability increases as the number of suppliers declines when there are few substitutes available.

3. What sources of information would you use to conduct a strategy analysis on an organization in Australia or New Zealand?

Strategy analysis involves industry analysis, competitive strategy analysis and corporate strategy analysis.

One secondary source of information for industry analysis, including competitive and corporate strategy analyses, is a commercial database that may be available at your library, such as IBISWorld, OneSource and Finanalysis. These are secondary sources because their analysis uses primary sources of information, and by using them you are relying on the accuracy of both their research and their interpretation.

Primary sources include industry association webpage and publications, and government statistical collections, such as are available from the Australian Bureau of Statistics in Australia. Information on the industry may also be found on the company's website, on the websites of its competitors, in newspapers, and in academic and practitioner journals.

It is also a useful starting point to examine the state of the economy or economies in which the company is operating. For a company operating in Australia or New Zealand, apart from the country of operation, that might also include countries from which raw materials are sourced or in which sales (as exports) are made. Sources of information on the economy of a country can be found on government websites, such as the Reserve Bank of Australia website, and the Australian Bureau of Statistics website in Australia.

4. One of the challenges of strategy analysis for an organisation in a smaller economy is finding sufficient competitors in its same industry. Apart from being in the same industry, offering the same products or services, what are other common factors between organisations that permit you to undertake an effective strategy analysis? What factors are not sufficient to permit an effective comparison? (For example, meeting the same customer needs with a different product or service may be sufficient, whereas being located in the same region may not.)

It is not possible to identify all of the common factors that could be appropriate for choosing a competitor for the wide range of companies operating in Australia and New Zealand. And in some unusual cases, it is conceivable that the factors that are identified below as insufficient may in fact be suitable. The following answer is therefore indicative, and can be considered as a useful base for a classroom discussion:

Effective common factors:

- Major customers, such as
  - Government
  - Manufacturing firm
  - Socio-economic group
- Similar economic drivers, such as
  - Demand for health products or services
  - Demand for security products or services
  - Demand for entertainment products or services
- Firm characteristics, such as
  - Similar size
  - Similar level of diversification
  - Similar capital structure
  - Similar age

- Similar regulations apply
- Similar business model (e.g., not-for-profit)
- Similar reliance on weather or season

Not effective common factors:

- Similar employees
- Similar suppliers
- Loss-making status
- Exposure to foreign exchange
- Region

5. In undertaking a strategy analysis, what are the difficulties of comparing organisations that dinner with respect to:

a. country of operation

b. products or services that meet the same customer needs

c. more than 30% of revenues coming from different sources

d. competitive advantage

e. industry classification

f. corporate strategy

a) Country of operation

- Different legal and regulatory requirements.
- Different cultural and social expectations and tastes.
- Currency is not a difficulty, as financial analysis uses ratios which abstract from the currency unit.

b) Products or services that meet the same customer needs

- Not all customers may use the product or service to meet the same need. For example, although train and air transport serve the same need for customers travelling long distances over land, and sea and air transport serve the same need for customers travelling long distances over sea, they are not substitutes for customers who need to take a car with them.
- There may be a future change in customer tastes that renders one product or service less popular.

- There may be a future change in costs due to a change in technology or other reason, which affects the product or service pricing and diminishes their substitutability.

c) More than 30% of revenues coming from a different source

- While there is always a chance that two companies will change to be less similar in the future, if one is already more diversified, then there is more chance of this happening, as the company may expand the operations of this one division (revenue source).
- If one company is more diversified, then the two companies may have different risks, depending on the combinations of industries in which they operate.

d) Competitive advantage

- The two companies may differ in ways that affect the comparability of their performance; for example, different profitability or different assets.
- The two companies may have different strategies.
- The two companies may respond differently to a change in the operating environment.

e) Industry classification

- It will be hard to find common information on their operating environment.
- Depending on the reasons for their different industry classifications, they may have different business models and they may face different cost pressures.

f) Corporate strategy

- The two companies may differ in which aspects of their operations are outsourced and which are retained in-house.
- The two companies may therefore differ in ways that affect the comparability of their performance; for example, different complexity, different profitability or different assets.
- They will face different cost pressures.
- The two companies may respond differently to a change in the operating environment.

6 ***One of the fastest growing industries in the last 20 years is the memory chip industry, which supplies memory chips for personal computers and other electronic devices. Yet the average profitability for this industry has been very low. Using the industry analysis framework, list all the potential factors that might explain this apparent contradiction.***

- **Concentration and Balance of Competitors:** The concentration of the memory chip market is relatively low. There are many players that compete on a global basis, none of which has a dominant share of the market. Due to this high degree of fragmentation, price wars are frequent as individual firms lower prices to gain market share.
- **Degree of Differentiation and Switching Costs:** In general, memory chips are a commodity product characterised by little product differentiation. While some product differentiation occurs as chip makers squeeze more memory on a single chip or design specific memory chips to meet manufacturers' specific power and/or size requirements, these differences are typically short-lived and have not significantly reduced the level of competition within the industry. Furthermore, because memory chips are typically interchangeable, switching costs for users of memory chips (computer assemblers and computer owners) encouraging buyers to look for the lowest price for memory chips.
- **Scale/Learning Economies and the Ratio of Fixed to Variable Costs:** Scale and learning economies are both important to the memory chip market. Memory chip production requires significant investment in 'clean' production environments. Consequently, it is less expensive to build larger manufacturing facilities than to build additional ones to satisfy additional demand. Moreover, the yield of acceptable chips goes up as employees learn the intricacies of the extremely complicated and sensitive manufacturing process. Finally, while investments in memory chip manufacturing plants are typically very high, the variable costs of materials and labour are relatively low, providing an incentive for manufacturers to reduce prices to fully utilise their plant's capacity.
- **Excess Capacity:** Historically, memory chip plants tend to be built in waves, so that several plants will open at about the same time. Consequently, the industry is characterised by periods of significant excess capacity where manufacturers will cut prices to use their productive capacity (see above).
- **Threat of Substitute Products:** There are several alternatives to memory chips including other information storage media (e.g., hard drives and disk drives) and memory management software that 'creates' additional memory through more efficient use of computer system resources.

- **Price Sensitivity:** There are two main groups of buyers: computer manufacturers and computer owners. Faced with an undifferentiated product and low switching costs, buyers are very price sensitive.

All the above factors cause returns for memory chip manufacturers to be relatively low.

7. Rate the leisure and hospitality industry and the mining industry as high, medium, or low on the following dimensions of industry structure.

- ***Rivalry***
- ***Threat of new entrants***
- ***Threat of substitute products***
- ***Bargaining power of buyers***
- ***Bargaining power of suppliers***

Mining firms historically have had relatively high rates of return, whereas hospitality and leisure firms have had relatively low returns. The following analysis reveals why.

	Hospitality and Leisure Industry	**Mining Industry**
Rivalry	*High* Firms compete fiercely for market share. The affluence of the economy has increased access to this market for many consumers, encouraging a rapid increase in the number of firms.	*Low* Firms specialise in mining in a particular geographic area or areas, limiting rivalry. Demand and prices have been strong, with the result that the total market has grown and rivalry has not been high.

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Threat of New Entrants	*High*	*Medium*
	Entry to this industry is often low cost, and it is not affected by much regulation. There is little advantage to a first mover, giving new entrants an equal chance with more established providers. Attempts have been made to reward loyalty, as a disincentive to new entrants.	Entry into the lumber industry requires access to mining leases and capital.
Threat of Substitute Products	*High*	*Low*
	There are many substitute products and services in this market.	Exploration is protected by leases, giving mining companies a monopoly in that region.
Bargaining Power of Buyers	*Low*	*High*
	Historically, consumers have had little buying power.	Many buyers are very large, including international companies and countries.
Bargaining Power of Suppliers	*Low*	*Not applicable.*
	There are few suppliers, and most of them are not well organised.	Supplies of timber for lumber are limited. Owners of timberland can sell to any lumber mill.

8 Joe argues: 'Your analysis of the five forces that affect industry profitability is incomplete. For example, in the banking industry, I can think of at least three other factors that are also important: namely government regulation, demographic trends and cultural factors.' His classmate Jun disagrees and says: 'These three factors are important only to the extent that they influence one of the five forces.' Explain how, if at all, the three factors discussed by Joe affect the five forces in the banking industry.

Government regulation, demographic trends and cultural factors will each impact the analysis of the banking industry. While these may be important, they can each be recast using the five forces framework to provide a deeper understanding of the industry. The power of the five forces framework is its ability to incorporate industry-specific characteristics into analysis for any industry. To see how government regulation, demographic trends, and cultural factors are important in the banking industry, we can apply the five forces framework as follows:

- **Rivalry Among Existing Firms:** Government regulation has played a central role in promoting, maintaining and limiting competition among banks. Banks are regulated at the federal and state levels. In the past, these regulations restricted banks from operating across state lines or even within different regions of the same state, and from paying market rates on deposits. The government also regulates the riskiness of a bank's portfolio in an effort to prevent banks from competing for new customers by taking on too many high-risk investments, loans or other financial instruments. These regulations have limited the degree of competition among banks. However, recent deregulation of the industry has allowed banks to expand into new geographic areas and to pay market rates on deposits, increasing the level of competition.
- **Threat of New Entrants:** Government regulations at both the federal and state levels have limited the entry of new players into the banking industry. New banks must meet the requirements set by regulators before they can begin operation. However, as noted above, deregulation of some aspects of banking has made it easier for out-of-state banks to enter new markets. Further, it appears to be relatively easy for non-banking companies to successfully set up financial services units (e.g., AT&T, GE and General Motors). Finally, as consumers have become more comfortable with technology, 'Internet banks' have formed. These 'banks' provide the same services as traditional banks, but with a very different cost structure.
- **Threat of Substitute Products:** The primary functions of banks are lending money and providing a place to invest money. Thrifts, credit unions, brokerage houses, mortgage companies, and the financing arms of companies, such as GMAC, provide potential substitutes for these functions. Government regulation of these entities varies dramatically, affecting how similar their products are to those of banks. In addition, with the expansion of superannuation and retirement savings accounts, consumers

have been become increasingly familiar with non-bank options for investing money. As another example, some brokerage houses provide money market accounts that function as checking accounts. As a result, the threat of substitutes for bank services has grown over time.

- **Bargaining Power of Buyers:** Business and consumer buyers of credit have little direct bargaining power over banks and financial institutions. The decline in relationship banking towards a transactions approach, where consumers seek the lowest-cost lender for each new loan, probably also reduces the buying power of customers.
- **Bargaining Power of Suppliers:** Depositors have historically had little bargaining power.

In summary, bank regulations have historically had a very important role in determining bank profitability by restricting competition. However, recent deregulation in the industry as well as the emergence of non-bank substitutes has increased competition in the industry.

9. Coca-Cola and Pepsi are both very profitable soft drinks. Inputs for these products include corn syrup, bottles/cans and soft drink syrup. Coca-Cola and Pepsi produce the syrup themselves and purchase the other inputs. They then enter into exclusive contracts with independent bottlers to produce their products. Use the five forces framework and your knowledge of the soft drink industry to explain how Coca-Cola and Pepsi are able to retain most of the profits in this industry.

While consumers perceive an intensely competitive relationship between Coke and Pepsi, these major players in the soft drink industry have structured their businesses to retain most of the profits in the industry by concentrating operations in its least competitive segments. Coke and Pepsi have segmented the soft drink industry into two industries – production of soft drink syrup and manufacturing/distribution of the soft drinks at the retail level. Moreover, they have chosen to operate primarily in the production of soft drink syrup, while leaving the independent bottlers with the more competitive segment of the industry.

Coca-Cola and Pepsi compete primarily on brand image rather than on price. They sell their syrup to independent bottlers who have exclusive contracts to distribute soft drinks and other company products within a specific geographic area. (While other syrup producers exist, they are typically regional and have very small shares of the market.) Given the large number of competing forms of containers for soft drinks (glass bottles, plastic bottles, aluminium cans, etc.), it is difficult for bottlers to earn any more than a normal return on their investment. Consequently, Coke and Pepsi can write exclusive contracts with bottlers prohibiting them from simultaneously bottling for a competitor. It is also difficult for independent bottlers to switch from Coke to Pepsi products, since there is likely to be an existing Pepsi bottler in the same geographic area. Consequently, independent bottlers have little bargaining power and Coke and Pepsi are able to charge them relatively high prices for syrup.

The threat of new entrants at the syrup level is restricted by limited access to adequate distribution channels and by the valuable brand names that have been created by both Coke and Pepsi. While soda syrup is relatively inexpensive and easy to make, a new syrup producer would have difficulty finding a distributor that could get its products to retail stores and placed in desirable shelf space. The high levels of advertising by Coke and Pepsi have created highly valued, universally recognised brands, which would be difficult for a potential competitor to replicate.

The main ingredients of syrup are sugar and flavouring, and the markets for these inputs are generally competitive. As a result, Coke and Pepsi exert considerable influence over their suppliers. For example, in the 1980s when corn syrup became a less-expensive sweetener than cane sugar, Coke and Pepsi switched to corn syrup. Thus, Coke and Pepsi are able to retain profits rather than pay them out to their suppliers.

The production and distribution of soft drinks at the retail level is likely to be less profitable than is syrup production for several reasons. First, despite tremendous amounts of advertising designed to create differentiated products, many people view sodas as being relatively similar and switching costs for consumers are very low, which makes it difficult to price one soft drink significantly higher than another. Secondly, there are a great number of substitutes for soft drinks, such as water, milk, juice, athletic drinks, etc., which consumers could switch to if the price of soda were to increase. Thirdly, because of low switching costs, consumers can be price sensitive and also exercise relative bargaining power over independent bottlers. Finally, as discussed before, the structure of the relationship between Coke and Pepsi and the independent bottlers gives Coke and Pepsi greater bargaining power over the bottlers, further limiting the ability of independent bottlers to keep a larger share of their profits.

10. In the 1980s and 1990s, many airline companies started frequent flier programs as a way to differentiate themselves in response to excess capacity in the industry. Many industry analysts, however, believe that this move had only mixed success. Use the competitive advantage concepts to explain why.

Initially, frequent flier programs had only limited success in creating differentiation among airlines. Airlines tried to bundle frequent flier mileage programs with regular airline transportation to increase customer loyalty and to create a differentiated product. Furthermore, the airlines anticipated that the programs would fill seats that would otherwise have been empty and would, so they believed, have had a low marginal cost.

However, because the costs of implementing a program were low, there were very few barriers to other airlines starting their own frequent flier programs. Before long, every airline had a frequent flier program with roughly the same requirements for earning free air travel. Simply having a frequent flier program no longer differentiated airlines.

More recently, airlines have had some success in differentiating frequent flier programs by creating additional ways to earn frequent flier mileage and increasing the number of destinations covered. Airlines have developed ‘tie-ins’ with credit card companies, car rental companies, hotels, etc. to allow members of a particular frequent flier program more ways to earn frequent flier mileage. They have also reached agreements with foreign airlines so that frequent flier mileage can be redeemed for travel to locations not served by the carrier. Finally, the programs have provided additional services for their best customers, including special lines for check-in and better flight upgrade opportunities. As a result of these efforts, airline programs have been somewhat successful in increasing customer loyalty.

11. What are the ways by which an organisation can create barriers to entry to deter competition in its business? What factors determine whether these barriers are likely to be enduring?

Barriers to entry allow a firm to earn profits while at the same time preventing other firms from entering the market. The primary sources of barriers to entry include economies of scale, absolute costs advantages, product differentiation advantages and government restrictions on entry of competitors. Firms can create these barriers through a variety of means.

1. A firm can engineer and design its products, processes and services to create economies of scale. Because of economies of scale, larger plants can produce goods at a lower cost than smaller plants. Hence, a firm considering entering the existing firm’s market must be able to take advantage of the same scale economies or be forced to charge a higher price for its products and services.
2. Cost leaders have absolute cost advantages over rivals. Through the development of superior production techniques, investment in research and development, accumulation of greater operating experience or special access to raw materials, or exclusive contracts with distributors or suppliers, cost leaders operate at a lower cost than any potential new entrants to the market.
3. A firm can engineer and design its products, processes and services to create economies of scale. Because of economies of scale, larger plants can produce goods at a lower cost than smaller plants. Hence, a firm considering entering the existing firm’s market must be able to take advantage of the same scale economies or be forced to charge a higher price for its products and services.

4. Differentiation of the firm's products and services may also help create barriers to entry for other firms. Firms often spend considerable resources to differentiate their products or services. Soft drink makers, for example, invest in advertising designed to differentiate their products from other products in the market. Other competitors that would like to enter the market will be forced to make similar investments in any new products.
5. Firms often try to persuade governments to impose entry restrictions through patents, regulations and licenses. AT&T fought with the government for many years to prevent other providers of a long distance telephone service from entering the market. Similarly, the local Bell operating companies have lobbied the federal government to write laws to make it difficult for other firms to provide local phone service.

Several factors influence how long specific barriers to entry are effective at preventing the entry of competitors into an industry.

- Economies of scale depend on the size and growth of the market. If a market is growing quickly, a competitor could build a larger plant capable of producing at a cost lower than the incumbent. If a market is flat, there may not be enough demand to support additional production at the efficient scale, which forces new entrants to have higher costs.
- Absolute cost advantages depend on competitors' difficulty in designing better processes. Some processes receive legal protection from patents. Entrants must either wait for the patent to expire or bear the expense of trying to invest around the patent. Similarly, differentiation advantages last only so long as a firm continues to invest in differentiation and it is difficult for other firms to replicate the same differentiated product or service.
- Incumbent firms and potential entrants can both lobby the government. If potential entrants launch intensive lobbying and public interest campaigns, laws, regulations and rules can change to ease entry into a once-protected industry. Several recent examples in the U.S. are deregulation of the airline, trucking, banking and telecommunications industries.

12. Explain why you agree or disagree with each of the following statements:

a. It's better to be a differentiator than a cost leader, since you can then charge premium prices.

b. It's more profitable to be in a high technology than a low technology industry.

c. The reason why industries with large investments have high barriers to entry is because it is costly to raise capital.

a. **Disagree:** While it is true that differentiators can charge higher prices compared to cost leaders, both strategies can be equally profitable. Differentiation is expensive to develop and maintain. It often requires significant company investment in research and development, engineering, training and marketing. Consequently, it is more expensive for companies to provide goods and services under a differentiated strategy. Thus, profitability of a firm using the differentiated strategy depends on being able to produce differentiated products or services at a cost lower than the premium price. On the other hand, the cost leadership strategy can be very profitable for companies. A cost leader will often be able to maintain larger margins and higher turnover than its nearest competitors. If a company's competitors have higher costs but match the cost leader's prices, the competitors will be forced to have lower margins. Competitors that choose to keep prices higher and maintain margins will lose market share. Hence, being a cost leader can be just as profitable as being a differentiator.

b. **Disagree:** There are highly profitable firms in both high technology and low technology industries. The argument presumes that high technology always creates barriers to entry. However, high technology is not always an effective entry barrier and can be associated with high levels of competition among existing firms, high threat of new entrants, substitute products and high bargaining power of buyers and/or sellers. For example, the personal computer industry is a high-technology business, yet is highly competitive. There are very low costs of entering the industry, little product differentiation in terms of quality, and two very powerful suppliers (Microsoft and Intel). Consequently, firms in the PC business typically struggle to earn a normal return on their capital. In contrast, Wal-Mart is a cost leader in a very low-tech industry, and is one of the most profitable companies in the U.S.

c. **Disagree:** The cost of raising capital is generally related to risk of the project rather than the size of the project. As long as the risks of the project are understood, the costs of raising the necessary capital will be fairly priced. However, large investments can act as high entry barriers in several other ways. First, where large investments are necessary to achieve scale economies, if additional capacity will not be fully used, it may make it unprofitable for entrants to invest in new plant. Secondly, a new firm may be at an initial cost disadvantage as it begins to learn how to use the new assets in the most efficient manner. Thirdly, existing firms may have excess capacity in reserve that they could use to flood the market if potential competitors attempt to enter the market.

13. There are very few companies that are able to be both cost leaders and differentiators. Why? Can you think of a company that has been successful at both?

Cost leadership and differentiation strategies typically require a different set of core competencies and a different value chain structure. Cost leadership depends on the firm's ability to capture economies of scale, scope and learning in its operations. These economies are complemented by efficient production, simpler design, lower input costs, and more efficient organisational structures. Together, these core competencies allow the firm to be the low cost producer in the market. On the other hand, differentiation tends to be expensive. Firms differentiate their products and services through superior quality, variety, service, delivery, timing, image, appearance or reputation. Firms achieve this differentiation through investment in research and development, engineering, training or marketing. Thus, it is the rare firm that can provide differentiated products at the lowest cost. Companies that attempt to implement both strategies often do neither of these well – and as a result suffer in the marketplace. Differentiation exerts upward pressure on firm costs, while one of the easiest sources of cost reduction is reducing product or service complexity, which leads to less differentiation.

Bunnings Warehouse, a lumber, hardware and home improvement company, is one example of a company that has been successful as both a cost leader and a differentiator. Bunnings operates hardware and lumber superstores that focus on do-it-yourself home improvement. While they stock tens of thousands of top quality items in each store, advertise extensively, and provide expert advice and service for customers (by employing a highly skilled and well-trained workforce that is knowledgeable about their products and home improvement), they are also able to provide low prices through aggressive purchasing and warehouse stores.

14. Many consultants are advising diversified companies in emerging markets such as India, Korea, Mexico and Turkey to adopt corporate strategies proven to be of value in advanced economies like the U.S. and the U.K. What are the pros and cons of this advice?

Corporate strategy involves making choices regarding the scope of a firm's business activities. As the chapter discusses, firm scope is a function of transaction costs in the market place. If the transaction costs in the market are high, internalising some of these activities inside a firm will be optimal. Transaction costs are a function of the degree to which intermediary institutions are developed. Emerging markets such as India, Korea, Mexico and Turkey have less developed market institutions compared to advanced markets such as the U.S. and the U.K. As a result, transaction costs in these economies are likely to be higher, leading to a different set of optimal firm scope choices. Therefore, replicating the strategic choices of advanced market companies in these economies will not be optimal.

15. Merger and acquisition activity is likely to bring advantages in terms of future profit potential from a strategic analysis perspective: reducing rivalry and bargaining power, for example. What are potential disadvantages of such activity, for future profit potential?

Potential disadvantages of merger and acquisition (M&A) activity for future profit potential:

- Empirical research has consistently shown that the shareholders of the acquirer lose and the shareholders of the target gain, due to the tendency for the acquirer to pay a price that outbids other potential acquirers, and the acquirer's incomplete knowledge about the target. This affects the firm directly if the cost of capital also increases in response to these factors.
- The time and cost of integrating both companies' systems including personnel is usually underestimated.
- The loss of key personnel in the target firm.
- The reduction of competition may:
    - attract other competitors to the industry;
    - attract closer government scrutiny and regulation.

16. Outsourcing 'non-core' business functions is sometimes considered to be a solution to corporate strategy problems. Identify advantages and disadvantages of outsourcing the following business activities for a university:

a. Cleaning

b. IT

c. Security

d. Payroll

e. On-campus food outlets

f. Marketing

Discussion may draw out examples for each of the following:

Outsourced business activities	**Advantages**	**Disadvantages**
a. Cleaning	Expertise required is quite different to other areas of university expertise, including cleaning workforce management and equipment.	Communication, co-ordination and planning may not integrate well with other university activities.
b. IT	Expertise required is quite different to other areas of university expertise.	University may require customized flexibility, responsiveness and specialised services.
c. Security	Expertise required is quite different to other areas of university expertise.	University image may be diminished.
d. Payroll	University operations may not require full time payroll activity, so it is more efficient to outsource it to a dedicated payroll operator.	Information security may be compromised.
e. On-campus food outlets	Expertise required is quite different to other areas of university expertise.	Communication, co-ordination and planning may not integrate well with other university activities.
f. Marketing	Expertise required is quite different to other areas of university expertise.	Lack of specific university knowledge; university image may be diminished.

End of Chapter Case: Solutions

Qantas

The following solutions are relevant at the time of writing. Instructors should use current material to supplement this analysis.

1. Analyse the competitive forces facing Qantas, using the 'five forces' framework from the strategy literature. Evaluate Qantas's prospects for profitability and growth in the next five years.

Applying the material in the case to the five forces, the following points are noted.

1. **Rivalry among existing firms:** High, due to falling profitability of the industry worldwide and new entrants to the Australian market.
2. **Threat of new entrants:** Low, while the industry's profitability remains low. However new entrants with a new business model, for example, low cost carriers, are a threat.
3. **Threat of substitute products:** Low, both domestically and internationally. Infrastructure for other transport modes is poor in Australia.
4. **Bargaining Power of Buyers:** Relatively high in a low profitability environment. Airlines face strong incentives to discount fares to fill spare capacity.
5. **Bargaining Power of Suppliers:** Relatively high, due to concentration of most inputs. Labour is a major factor for Qantas, and its bargaining power appears to be weakening.

Based on the five forces framework, prospects for growth are moderate in the next five years. However, prospects for profitability improving are low.

2. Identify the limitations of this analysis. What other factors do and could affect Qantas's competitive environment?

Like all analyses, this is limited by the information available. Other factors that are relevant at the time of writing include:

- Government regulation that might increase regulation to either protect the domestic industry or open the market to more suppliers.
- Health issues around the world, which might decrease the demand for air travel, or make Australia a chosen destination.

- Air New Zealand is a profitable carrier and may expand its operations into Australia.
- Major air disasters may decrease the demand for air travel.
- Economic changes in Australia, such as inflation, economic growth, as well as worldwide economic changes, such as another financial crisis.

3. Discuss Qantas's competitive strategy since 2000. Is it successful, and is it sustainable?

Qantas's strategy has been that of cost leadership, particularly in the domestic market. To an extent this strategy has been imposed by the market, as the model of differentiation would be a challenge to sustain in the modern air transport industry. At the same time Qantas has sought to maintain services, so in some ways its attempts to provide convenience to its customers is a differentiation strategy.

The strategy has not been successful, as Qantas has not been able to undercut other suppliers and gain market share or improved profitability. It is also a difficult strategy to sustain unless Qantas finds new ways to cut costs in the future to maintain profitability.

4. What is Qantas's competitive strategy, if any? Apply a SWOT (Strengths, Weaknesses, Opportunities and Threats) evaluation to it.

Qantas has a competitive advantage in its brand, which is a result of its safety record, and its access to Australian travelers.

- **Strengths:** The Qantas brand is unique and well known around the world. In the light of safety threats involving other airlines, the value of a strong safety record will increase. Due to the ageing Australian population with more leisure time in retirement, its potential future sales are high.
- **Weaknesses:** The Qantas brand is associated with travel to and from Australia, and not on other routes. It is not as well known to international travellers coming to Australia as it is to domestic travellers. Qantas also operates Jetstar which does not have the advantage of its strong brand name.
- **Opportunities:** Qantas can diversify into other areas of travel – e.g., bus tours, car rental, accommodation – capitalising on its brand name.
- **Threats:** Its safety record could easily be degraded in the event of a major accident.

5. What has been Qantas's corporate strategy across its domestic and international divisions since 1992? How has that strategy changed in response to market changes? Have any changes been initiated by Qantas?

In 1992, the Australian Government removed the barrier between the provision of international and domestic air transport in Australia, and Qantas (re)commenced operating in both markets. It operated under the one operating structure in both markets until 2003, when it started a low-cost carrier Jetstar as a wholly owned subsidiary. This meant that it had two airlines, one full-cost and one low-cost, in both markets. Its operational fragmentation continued in 2012 when Qantas announced the intention to separate its domestic and international operations (again). The strategy has been more in response to market changes, but its effect has been to fragment and replicate Qantas's operating structures, in the hope of reducing costs.

In other aspects of its operations, Qantas's history shows that it has both built up new operating activities in response to competition, and outsourced activities or sold off areas of its operations that were profitable (such as its Frequent Flyers loyalty program). Again, this strategy has been in response to market changes, in the pursuit of both improving brand loyalty and reducing costs.

6. Prepare an executive summary of recommendations to the Qantas executive, based on your analysis. Identify three key changes to its structure and/or operations.

Students should identify a small number of problems facing Qantas at the time of preparing their answer, and suggest three significant changes that are clearly linked to these problems. Their solutions should not copy what other airlines are doing, and if possible should capitalise on Qantas's competitive advantages.