# *Edexcel*

# *A Level*

# *Business studies*

## *(Code: WEC13 01)*

## *Unit 03-Section 01*

## *Business decisions and strategy*

# Chapter 1 – Cooperate objectives

### BUSINESS AIMS

All businesses have aims. These are the things the business wants to achieve in the long term - its purpose or reason for being. The aims of a business are less specific than its objectives and can be expressed as a vision.

## MISSION STATEMENTS

A mission statement states the business's main purpose. It may also reflect its goals and values. It describes in general terms the company's core activities. It may also reference information such as:

- the markets in which it operates
- what its key commercial objectives are
- in what way it values its **stakeholders**
- what its ethics involve (i.e. what it believes to be good or correct).

The main elements of a mission statement are as follows.

• **Purpose** - a mission statement should outline why the business exists. It should communicate what the business does, for whom and why.

• Values businesses are likely to state the corporate values that they emotionally invest in. These might include qualities such as integrity, sustainability, innovation and quality.

• Standards and behaviour - some mission statements may communicate a business's commitment to high standards. For example, always conducting ethical behaviour

• Strategy - some mission statements may outline how the business will try to achieve its main objective.

Some mission statements are brief. Others are long and detailed. Some examples of mission statements are given below.

• R&F Fitness Centre: 'We improve levels of fitness by providing individual plans for people of all ages and helping them to achieve their aims.'

• R&B Furniture Maker: 'To help create practical and beautiful homes for our customers.'

• DHC Coffee Shop: 'To offer a comfortable environment and an excellent range of coffee to refresh our customers in body, mind and spirit."

### DEVELOPMENT OF CORPORATE OBJECTIVES

Corporate objectives are specific, measurable, agreed upon, realistic, and time-specific goals set by senior managers and directors for a company. They should focus on desired performance and results over time, including market share, profit levels, and ethical behaviours. SMART criteria help achieve these objectives.

• Specific means that the objective clearly states what the business is aiming to achieve. It should refer to a particular aspect or function of the business.

• Measurable involves evidence to demonstrate whether or not the objectives have actually been achieved. For this reason, most corporate objectives will have a financial or quantifiable element (i.e. an element that can be expressed by a number). This is because it makes it easier to measure the success of that objective.

- Agreed implies that everyone responsible for achieving the objective is happy with the objective and understands what it means for them.

- Realistic ensures that the objective can be met given the resources available and the current market conditions. If an objective is unrealistic, people may begin to ignore it. This means that the objective will not be achieved.

- Time specific gives the stated time frame required to achieve the objectives. All objectives must have a deadline to ensure urgency and a point at which the objective can be assessed.

## DEPARTMENTAL AND FUNCTIONAL OBJECTIVES

General objectives originate from a business's mission statement and guide its daily goals, including human resources, finance, operations, logistics, and marketing. These objectives are referred back to the corporate objectives and mission statement, ensuring consistency in business activities. Functional objectives support these corporate objectives, ensuring alignment between business functions. For instance, a departmental objective to reduce waste may be aligned with HR objectives to ensure quality management training.

THE OBJECTIVES HIERARCHY


An objective will ultimately flow from the firm's overall aim and be effective if it contributes to achieving the level above.

▲ Figure 1 Objectives hierarchy

## THE DIFFERENCE BETWEEN SMALL AND LARGE FIRMS

Chapter 1 in Student Book 1 explores the possible objectives that may motivate a business. Usually, a business aims to make a profit. However, it may have other goals as well, such as:

- maximising sales, sales revenue or market share
- achieving cost efficiencies
- looking after its employees
- ensuring that its customers are satisfied.

Small businesses may have a wide variety of objectives, such as the following examples:

- to ensure that the company **breaks even** at the end of the tax year (see Student Book 1, Chapter 31)

- to improve the firm's liquidity in the next six months (see Student Book 1, Chapter 35)
- to increase sales by 10 per cent over the next three years (see Student Book 1, Chapter 30)
- to increase pre-tax profits by 5 per cent over the next 12 months (see Student Book 1, Chapter 34)
- to hire five new staff with skills in sales and marketing and build a strong marketing department over the next year
- to reduce energy consumption by 2 per cent and cut the use of non-recyclable packaging over the next three years.

### CRITICAL APPRAISAL OF MISSION STATEMENTS AND CORPORATE AIMS

Mission statements can be unrealistic, demotivating, and insincere, potentially causing demotivation and wasted management time. They may also appear vague and insincere, potentially causing stakeholders to view them as marketing tools. Therefore, mission statements must be constantly assessed for relevance.

However, businesses may need to consider the balance of the appeal of some of these objectives to their customers. This is especially true if the organisation is not achieving a profit for **shareholders**.

A critical reassessment (i.e. assessing what is good. and bad about something) should involve an appraisal (i.e. a judgement of the value) of the following.

- What is the purpose of the mission statement?
- What audience is it intended for?
- How does the business strategy fit in with its stated mission?
- Are the aims and objectives realistic and achievable?

**SUBJECT VOCABULARY**

**break-even** when a business generates just enough revenue to cover its total costs
**corporate aim** the specific goal a corporation hopes to achieve. For example, to become market leader
**corporate objectives** the objectives of a medium to large-sized business as a whole
**departmental and functional objectives** the objectives of a department within a business
**hierarchy** the order or levels of responsibility in an organisation, from the lowest to the highest
**mission statement** a brief statement written by the business, describing its purpose and objectives, designed to cover its present operations
**objective (or goal)** a target of, or outcome for, a business that allows it to achieve its aims
**shareholder** somebody who owns shares (i.e. one of the parts a company is divided into) in a company or business
**SMART** acronym for the attributes of a good objective: Specific, Measurable, Agreed, Realistic and Time specific
**stakeholder** somebody who has invested money in a business or has an important connection with it. They are therefore affected by the success or failure of the business
**vision** a view of what the corporation wants to be like in the future

# Chapter 2 Theories of corporate strategy

### BUSINESS STRATEGY

Business strategy is a crucial process for achieving corporate objectives. It involves using analytical tools to understand the current market position and evaluating the company's future goals. A SWOT analysis and Five Forces Analysis are used to evaluate the business's position. A successful strategy provides a competitive advantage and fulfills stakeholder expectations. A successful strategy helps businesses gain an advantage in the market and fulfills their objectives, ensuring they remain competitive and meet their goals.

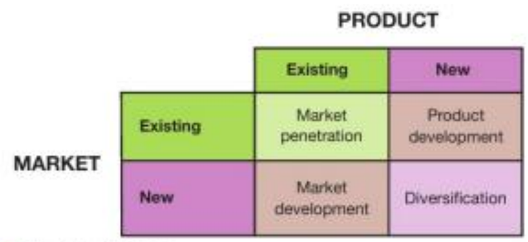
### DEVELOPMENT OF CORPORATE STRATEGY

Strategic planning involves critical evaluation of a business's past performance and future needs to achieve corporate objectives. Tools like Ansoff's Matrix, Porter's Strategic Matrix, and portfolio analysis can aid in this process, requiring significant time and research.

### ANSOFF'S MATRIX

Igor Ansoff was an applied mathematician and business strategist. He developed Ansoff's Matrix as a strategic tool to help a business achieve growth. Figure 1 illustrates both existing and new products within existing and new markets. Ansoff's Matrix is a useful decision- making tool because it allows the owners of a business to consider a number of factors that will determine its corporate strategy:

- the level of investment in existing and new products
- the exploitation of different markets
- the growth strategy for the business
- the level of risk the business is willing to accept.




▲ Figure 1 Ansoff's Matrix

Market penetration: As suggested by Ansoff's Matrix, the purpose of market penetration is to achieve growth in existing markets with existing products. There are several ways a business can achieve this:

- increase the brand loyalty of customers so that they use substitute brands less frequently. An example might be adopting a loyalty scheme, such as the loyalty card introduced by small restaurant chain Casa Brasil. This card offers points that provides holders with discounts at the restaurants.
- encourage consumers to use the product more regularly. An example might be encouraging people to eat breakfast cereal as a night-time snack.
- encourage consumers to use more of the product. An example might be a crisp manufacturer producing maxi-sized crisp packets rather than standard-sized crisp packets.

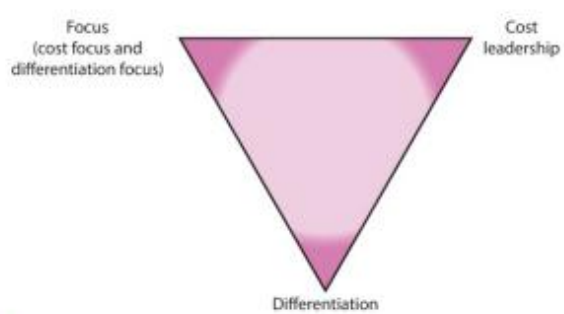
**Product development**: Product development is concerned with marketing new or modified (i.e. improved by small changes) products in existing markets. This might be an appropriate strategy to adopt where the product life cycle is traditionally short, or where trends or technology change quickly. This strategy is associated with product innovation and continuous development. The confectionery market is famous for product development.

**Market development**: Market development involves the marketing of existing products in new markets. The most basic form of the strategy is entering geographically new markets. This is not always simple. Tastes and preferences may be different in regions of the same country, let alone between countries. A market development strategy relies heavily on understanding local habits, tastes and needs.

**Diversification**: Diversification occurs when new products are developed for new markets. It enables a business to move away from depending upon existing markets and products. Therefore, it allows the company to spread risk and increase safety. If one product faces difficulties or fails, a successful product in another market may prevent the overall business facing problems.

## PORTER'S STRATEGIC MATRIX

Porter's Strategic Matrix was developed by Michael Porter, a professor at Harvard Business School, to identify the sources of competitive advantage that a business might achieve in a market. Porter stated that any business that does not adopt one of these three generic strategies is 'stuck in the middle' and unlikely to succeed.




▲ Figure 2 Porter's Strategic Matrix

**Cost leadership**: This involves striving to be the lowest-cost provider in the market. This does not necessarily mean that the business will offer the lowest price, although this may be an option. Generally, the firm that is able to operate as the lowest-cost provider in a market will compete in two ways:

- increasing profits, while still charging market level prices
- increasing market share, while charging lower prices (still making a profit since costs are reduced).

**Differentiation**: This involves a business operating in a mass market with a unique position instead of the lowest-cost position. Unlike cost leadership, a differentiation strategy may be adopted by any business, provided that it can deliver a way of differentiating itself from the competition.

One company that has done well by differentiating its products is Airstream®, the US caravan producer. It produces iconic luxury caravans. The products are very different from the majority of caravans and recreational vehicles (RVS) in the global market.

**Focus**: This strategy involves targeting a narrow range of customers in one of two ways. A focus strategy is closely aligned to niche marketing (see Chapter 33). It tends to be used by small or very specialist firms. As a business is focusing on a very narrow segment of the market, it is able to gain an advantage by understanding its customers very well.

A focus strategy can take one of two forms.

● Cost focus - emphasising cost minimisation within a focused or niche market. The German supermarket chain AldiR is a good example of this strategy. Although it does not operate as the cost leader in the market, it is able to offer a focused range of products at very low prices.

● Differentiation focus - following different strategies within a focused market. Ferrari® is an example of this strategy. Its high-performance cars are targeted at a very small percentage of the population.

## AIM OF PORTFOLIO ANALYSIS

Portfolio analysis is a method of categorising (i.e. grouping according to type) all of the products of a firm (its 'portfolio') in order to decide where each one fits within the strategic plans. The products are then evaluated according to their competitive position and potential growth rates. This involves a two-step process.

Step 1: Give a full and detailed overview of all of the products in the current business portfolio.

• Step 2: Look at the performance of each of these products and services by examining:

- current and projected sales
- current and projected costs
- competitor activity and future competition
- risks that may affect performance.

Next, the Boston Consulting Group Matrix (or 'Boston Matrix' / Growth Share Matrix) categorises these products into one of four different areas based upon their current and potential market share or market growth.

1 **Stars** are high-growth products that are strong compared to those of competitors. Stars require investment, but the hope is that they will become cash cows.

2 **Cash cows** are low-growth products with high market shares. They generate more cash than they consume, and so can provide a return for investors and fund investment in other areas.

3 **Question marks** are products with low market shares in high-growth markets. They consume a lot of cash but give little return. However, they have the potential to turn into stars. Keeping these lines requires a belief that there is a potential for growth.

4 **Dogs** are products with low market share in low-growth markets. They may break even, but nevertheless take up time and effort with little prospect of future growth. They should be sold or divested.

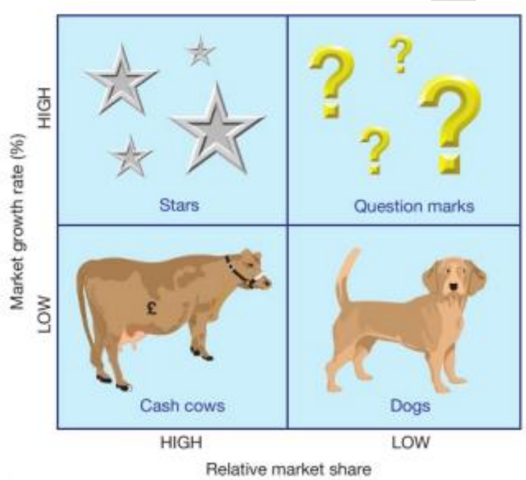
## EFFECT OF STRATEGIC AND TACTICAL DECISIONS

Strategies outline a business's long-term direction, while tactics are short-term responses to market opportunities or threats. Tactical decisions are often made independently from the wider situation, focusing on current business conditions. Strategic decisions are based on CEO and board guidelines, while tactical decisions occur at managerial or supervisory levels. Strategic and tactical decisions impact a business's resources differently.

**Human resources**: Strategic decisions have a long-lasting impact on the workforce, such as increasing workforce size or recruiting different labor types. Tactical decisions, on the other hand, may only affect a small proportion of the workforce for a short period, such as an ice cream manufacturer opening at weekends to cope with increased demand due to warm weather.

**Physical resources**: Physical resources in a business include land, machines, tools, equipment, vehicles, shops, computers, factories, and raw materials. Strategic decisions can impact these resources, ranging from selling off delivery vehicles to developing new products or requiring more research equipment or raw materials. Tactical decisions, such as meeting large customer demands, can also impact physical resources.

**Financial resources**: Strategic decisions significantly impact a business's financial resources, such as raising $200 million through shares for acquisition, while tactical decisions, like going overdrawn for delayed customer payments, have a short-term effect. Long-term effects include meeting dividend payments, while tactical decisions, like going overdrawn, may not significantly affect a company's finances.




▲ Figure 3 The Boston Matrix

Based on The BCG Portfolio Matrix from the Product Portfolio Matrix, © 1970, The Boston Consulting Group (BCG)

**SUBJECT VOCABULARY**

**corporate strategy** the plans and policies developed to meet a company's objectives. It is concerned with what range of activities the business needs to undertake in order to achieve its goals. It is also concerned with whether the size of the business organisation makes it capable of achieving the objectives set

**customer base** a group of customers that make continual repeat purchases from a business

**diversification** developing new products in new markets

**market development** the marketing of existing products in new markets

**market penetration** using tactics such as the marketing mix to increase the growth of existing products in an existing market

**portfolio analysis** a method of categorising all the products of a firm (its portfolio) to decide where each one fits within the strategic plans

**product development** marketing new or modified products in existing markets

**theoretical model** a situation that could exist but doesn't really

# Chapter 3 Swot Analysis

## GATHERING INFORMATION TO HELP DEVELOP A STRATEGY

When making plans or developing a business strategy it is important to gather appropriate information. A business can use a variety of methods to do this.

**The internal audit**: An internal audit is an analysis of the business itself and how it operates. It attempts to identify the strengths and weaknesses of its operations. It might cover areas such as:

- products and their costs, quality and development finance, including profit, assets and cash flow
- production, including capacity, quality, efficiency and stock management
- internal organisation, including divisional and departmental structures
- human resources, including skills, training and recruitment.

**The external audit**: An external audit is an analysis of the environment in which the business operates. The business has little or no control over it. This audit may deal with three key areas: the market, competition and the political, economic, social, technological, legal and environmental issues relevant to the business.

The audit should analyse the market or markets in which the business operates. For example, it should analyse:

- the size and growth potential of the market
- the characteristics of the customers in the market
- the products on offer
- the pricing structure
- how products are distributed
- how products are promoted
- industry practices, such as whether there is a **trade association** or government regulation.

The audit should also analyse the competition in the market. The nature and strength of competitors will be an important influence on the development of a strategy. For example, it should analyse:

- the structure of the industry (including the number and size of competitors)
- the production capacity and marketing methods of competitors
- how likely it is that there will be new entrants to the market
- how likely it is that businesses will leave the industry
- the profits of competitors
- competitors' investments programmes, costs, revenues, cash and assets.

## WHAT IS SWOT ANALYSIS?

It is helpful if the information gathered can then be summarised and presented in a meaningful way. One approach is to use **SWOT analysis**.

SWOT analysis might be used by senior managers before drawing up a **strategic plan**. It helps to give an idea of the advantages and disadvantages of a particular decision. It might also help to make the current position of a business easier to understand.

**Strengths**: These are the positive aspects of a business that may be identified from the internal audit. Strengths are what the business is good at - they are what help make the business a success. Examples might include:

- a respected, intelligent, inspirational and visionary leader
- a highly motivated and loyal workforce
- a product with a unique selling point
- state-of-the-art production facilities
- a loyal customer base (i.e. the people who buy the product)
- an innovative marketing department (i.e. one that uses new methods and ideas).

**Weaknesses**: These are the negative aspects of a business that may be identified from the internal audit. Weaknesses are what the business lacks or does poorly; for example, in relation to its competitors. They are the characteristics that undermine the performance of a business - perhaps preventing it from growing. They are also areas for improvement. Examples might include:

- a poorly motivated workforce with a high staff turnover (i.e. the rate at which workers leave)
- an organisational structure that has too many layers of management
- a product range that is getting out of date
- poor cash flow and growing debt
- outdated tools and machinery
- a poorly presented and out-of-date website.

**Opportunities**: The external audit should show up what opportunities are available to the business. These are the options or openings that the business might be able to exploit - resulting in improvements, such as higher revenues or lower costs. Examples might include:

- a new overseas market opening up following a political change
- a fall in the cost of an essential raw material, such as oil
- low interest rates, which provide cheap finance for investment
- a fall in the exchange rate, which will make exports cheaper
- some difficult regulations being abolished
- the failing of a major rival in the market.

**Threats**: The external audit should show up what threats face the business. Threats are the possible dangers that have the potential to damage the performance of the business. Examples might include:

- a new entrant in the market
- a rival employing a new and highly successful CEO a probable recession
- new legislation (i.e. laws) aimed at improving the rights of employees
- increasing pressure from environmentalists
- a change in social attitudes towards the business's key product.

SWOT analysis is often carried out in mind-mapping sessions before being documented (i.e. officially recorded). It can be a powerful way of summarising and building upon the results of internal and external audits. Clearly, it will be a useful tool when developing a corporate strategy, but it may have other uses. For example, it might be used to:

- decide which new product to launch
- design a new marketing strategy
- decide whether to outsource a specific business task or activity, such as IT
- prepare for a completely new business venture plan a restructuring of the business.

## AN EXAMPLE OF A SWOT ANALYSIS

Swedish chocolate maker, Choklad Extas, is an established and well-known confectioner. It has been trading for over 50 years and has around 130 shops located in ideal positions around Sweden and Norway. In 2017, the business made a pre-tax profit of SEK97 million. However, a profit warning in December 2017 suggested that this might be difficult to match.


▲ Figure 1 SWOT analysis for Choklad Extas

### SUBJECT VOCABULARY

**external audit** an audit of the external environment in which a business finds itself, such as the market within which it operates or government restrictions (i.e. limits) on its operations
**flotation** the sale of company shares to the public for the first time. The shares are then traded on the stock market
**internal audit** an analysis of the business itself and how it operates
**strategic planning** a process which involves making the vision for the future of a business easier to understand. It also involves identifying the goals that need to be achieved in order to realise that vision
**SWOT analysis** an analysis of the internal strengths and weaknesses of the business and the opportunities and threats presented by its external environment
**trade association** an organisation whose members are all involved in the same industry or trade. The organisation pursues the interests of these businesses

# Chapter 4 Impact of external influences

## EXTERNAL INFLUENCES

Sometimes, businesses have to deal with events and issues that are completely beyond their control. These are called external influences and can impact on businesses unexpectedly. They usually mean that businesses have to make changes to the way they operate. The effects of external influences can be both positive and negative.

## PESTLE ANALYSIS

External influences on businesses can have significant positive or negative effects, such as falling interest rates boosting profits and encouraging investment, or rising interest charges and falling demand for goods funded by borrowing. Monitoring and analyzing these influences, such as using **PESTLE analysis**, can help businesses navigate these challenges.

**Political**: Some parts of the world are politically unpredictable. It is important to pay special attention if businesses try to operate in politically unstable countries. However, political factors can also influence businesses in stable countries.

The activities of pressure groups can play a role in influencing business activity. Some examples of political factors include the following.

• Members joining or leaving a trading bloc. This could disrupt financial markets and create a great deal of uncertainty. For example, in 2016, the UK voted to leave the EU.

• The issue of national security has become a priority for many governments. If measures designed to improve national security restrict the movement of goods, people and capital, this could have either a positive or a negative impact on businesses.

• Pressure groups such as trade unions, which aim to protect the rights of workers, can affect businesses. For example, they may be able to force up wages for their members. This will raise business costs.

• Changes in government. For example, a new government may want to introduce laws which might have an impact on some businesses.

**Economic**: The general state of the economy can have a huge impact on business activity. Since the financial crisis in 2008, a number of countries have suffered a recession. This has made trading conditions very difficult for many businesses. However:

- falling unemployment might help to increase demand for many businesses
- stable prices would create more certainty, which should encourage businesses to invest for the future
- a strengthening exchange rate might make exporting more difficult but it might also make importing cheaper
- lower interest rates would make borrowing cheaper and encourage more investment
- some businesses may suffer badly during a recession.

**Social**: Over time there are likely to be changes in the way society operates. Although social and cultural changes tend to be gradual, they can still have an impact.

In some countries, greater numbers of people are going to university. This could increase the quality of human resources, which might benefit certain businesses.

• The population in many countries is ageing. This could affect demand patterns and create new opportunities for some businesses.

• Increasing migration (i.e. large numbers of people moving from one place to another) might increase the size of the potential workforce, making recruitment easier. It might also provide a boost to demand.

• People appear to be becoming more health conscious. This might create opportunities for certain businesses, such as those selling healthy foods or running fitness centres.

**Technological**: The rate of technological change seems to be increasing all the time. Businesses usually welcome technological developments because they can provide new product opportunities or help to improve efficiency.

• Changes in technology can shorten product life cycles. This is because new products are quickly developed to replace ones that use older technology.

• Developments in technology often mean that businesses can replace labour with machines. This is welcomed because human resources are often said to be the most expensive and difficult to manage. New technology also lowers unit costs.

• The development of social media has helped to improve communications between businesses and customers. This allows businesses to keep track of changing consumer needs.

**Legal**: The government provides the legal framework in which businesses operate. However, it also directs legislation at businesses to protect vulnerable groups (i.e. groups that are easily hurt or damaged) that might otherwise be exploited. EU businesses are also affected by EU regulations.

- EU legislation can affect tax laws.
- Businesses in the food industry are currently under pressure to reduce the amount of sugar and salt they add to products. In some countries, governments have imposed taxes on the use of sugar in certain products
- In some countries, the government states that it wants to reduce the number of rules and regulations addressing business behaviour. This might benefit a wide range of businesses.

**Environmental**: People are increasingly protective of the environment; for example, because of the threats posed by global warming. Business activities also sometimes threaten wildlife and natural habitats.

• Some people prefer to buy environmentally friendly goods. This provides opportunities for businesses that specialise in these products.

• There are new ways of generating power using renewable sources rather than by burning fossil fuels, such as oil and coal, which are providing new opportunities.

• The trend towards recycling is gathering pace in many countries. By using recycled resources, businesses can cut their costs.

## IMPACT OF EXTERNAL INFLUENCES

The impact on businesses of the external influences discussed above could be wide ranging, depending on the nature of the factor. However, some examples are outlined below.

**Demand**: Businesses will be concerned if external influences reduce demand for their products. This is likely to result in lower revenues, lower profits and weaker cash flows. For example, a sharp rise in the exchange rate will have a negative impact on most businesses that rely heavily on exports. In contrast, importers such as retailers will benefit from the rise. Their purchases will be cheaper and so they may sell more.

**Costs**: Some external influences are likely to raise costs. This will reduce profit margins or force businesses to raise their prices. For example, a surge in the global oil price will raise costs for many businesses. This is because oil is an important input for many businesses - particularly in manufacturing.

**Operations**: Businesses often have to change their operational methods as a result of an external influence.

## THE STRUCTURE OF MARKETS

Competition refers to the rivalry between firms in a specific market, with high levels in markets like Los Angeles' restaurant market and low levels in France's rail transport sector.

**Competitive markets**: In a competitive market, there are numerous buyers and sellers, with products being close substitutes. Low barriers to entry and minimal control over price are common. Information about product nature, availability, prices, production methods, and production factors is freely available.

**Uncompetitive markets**: Some markets are dominated by a single producer or just a few large businesses. In a small number of markets, such as rail travel and water supply, a **monopoly exists**.

A market that is dominated by a few very large producers is called an **oligopoly**.

## THE CHANGING COMPETITIVE ENVIRONMENT

Market structure changes over time, with competition intensifying as new businesses enter or established businesses diversify. Governments have reduced regulation to make markets more competitive, like allowing local councils to operate bus services. However, some markets have experienced consolidation, with fewer businesses in the market. This has led to increased competition and diversification in the industry.

Some examples of changes in the competitive environment are outlined below.

• Retailing has become more competitive due to an increase in the number of consumers using online shopping facilities. For example, people can buy products from all over the world when shopping online, e.g. from Amazon or Ali Baba®.

• The global airline industry has experienced significant consolidation, with 11 US airlines sharing 96% of the domestic market in 2005. European mergers, such as IAG, Air France, KLM, Swiss Air, and Lufthansa, have further consolidated the market.

• In India, the handheld mobile phone market, which was thought to be worth $15 billion in 2017, is expected to consolidate. There were about 100 brands, but intense competition is expected to reduce this number in the near future. Industry analysts say that the market will be consolidated because it is not possible for smaller competitors to survive.

## THE IMPACT ON BUSINESSES OF ACHANGING COMPETITIVE ENVIRONMENT

Many markets are dynamic (i.e. continuously changing) and businesses need to be aware of the changes that are taking place. They may have to react to certain changes when they occur.

**New entrants**: When new entrants in the market increase competition, existing businesses have to consider their position.

**New products**: When a new product appears in the market, businesses may be forced to make changes of their own. They might adapt their own products, lower the price of existing products or invest in an aggressive marketing campaign.

**Consolidation**: Consolidation in markets leads to smaller businesses becoming more competitive, potentially threatening others. Other businesses may merge, diversify, or accept lower profit margins. Failure to respond effectively can negatively impact a business's performance and even threaten its survival. Failure to adapt can lead to market consolidation.

## PORTER'S FIVE FORCES

Michael Porter's Competitive Advantage model outlines five factors determining industry profitability. The ultimate goal of competitive strategy is to change these forces in favor of the business, resulting in acceptable or average returns on investments. Unfavorable forces lead to low or unpredictable returns.

The five forces, shown in Figure 4, are as follows.


▲ Figure 4 The five competitive forces that determine industry profitability

**The bargaining power of suppliers**: Suppliers, like any business, want to maximise the profit they make from their customers. The more power a supplier has over its customers, the higher the prices it can charge and the more it can reallocate (i.e. move) profit from the customer to itself. Limiting the power of its supplier will therefore improve the competitive position of a business. It has a variety of strategies it can adopt to achieve this.

**The bargaining power of buyers**: Suppliers want to charge maximum prices to customers, and buyers want to obtain supplies for the lowest price. If buyers or customers have considerable market power, they will be able to beat down prices offered by suppliers.

**The threat of new entrants**: If businesses can easily enter an industry and exit if profits are low, it becomes difficult for existing businesses in the industry to charge high prices and make high profits. Existing businesses are constantly under threat from new suppliers if the profits in an industry rise too much. This is because the new suppliers can undercut their prices.

**Substitutes**: The more substitutes there are for a particular product, the fiercer the competitive pressure on a business making the product. Equally, a business making a product with few or no substitutes is likely to be able to charge higher prices and make high profits. A business can reduce the number of potential substitutes through research and development, and then patenting the substitutes itself.

**Rivalry among existing firms**: The degree of rivalry among existing firms in an industry will also determine prices and profits for any single firm. If rivalry is fierce, businesses can reduce that rivalry by forming **cartels**, or engaging in a broad range of anti-competitive practices.

### SUBJECT VOCABULARY

**cartel** a group of businesses that act together to reduce competition in a market – by fixing prices, for example
**monopoly** a market dominated by a single business
**oligopoly** a market dominated by a few large businesses
**peer-to-peer (P2P) lending** providing loans to individuals or businesses through online services that match lenders with borrowers
**PESTLE analysis** analysis of the external political, economic, social, technological, legal and environmental factors affecting a business
**predatory (or destroyer) pricing** setting a low price to force rivals out of business
**rivalry** the competition that exists between businesses operating in the same market