In this chapter we will address the central issue of how markets work and what influences the nature of competition across the whole value chain of a product or service. The chapter starts by introducing a framework which helps us to understand the nature of competition, and to identify the key determinants of the nature of competition in a market or industry. Following this we identify factors or influences which shape the way in which a market develops. We also consider the different stages of development of the industry. We conclude the chapter by looking at an example and flagging some key issues for consideration in subsequent chapters.

3.1 Analysing Industries and Markets

In order to understand the industry or a market we first need to identify what market or markets we are interested in. As we saw in the previous chapter we should therefore be clear about the needs of the customers and who it is that customers see as the competition. The key point here is that it is the buyer of the product or service that determines and defines the market. Consider the case of a business selling used cars. The firm has a certain amount to spend on advertising and promotion. There are a number of alternatives available. For example, they could advertise in a local newspaper, they could buy advertising space on local radio, rent some hoardings, or purchase off-peak time on regional TV. For this particular business these are just some of the alternatives, having due regard to costs and effectiveness, that could be used to meet promotional and advertising needs. So, if we were responsible for managing the local radio station we would need to consider that the competitors for advertising revenues were not just other local radio stations but all other forms of media in that town or region. In order to identify in more detail the markets that we are considering we must first identify the
needs of the buyers and then identify competition from their perspective.

Having established an acceptable definition of the market we are interested in, we can analyse systematically the competitive forces that are influencing this market. Firms rarely operate in just one, clearly defined, homogeneous market. Usually a firm operates in several markets, and within each market there are likely to be distinct segments of demand – segments being groups of buyers with similar needs. For example, a French cycle manufacturer may be competing in the home market as well as exporting to a number of countries in Europe. Within the French market there may be a number of segments of demand, for example adult racing bikes, bikes for girls aged three to six and so on. It can be useful to try to assess the European cycle market as a whole (using the techniques explained below) but it is usually necessary to follow up this broad assessment with analyses of specific markets and segments within markets.

Porter (1980) has constructed a useful framework for analysing the structure of an industry (Figure 3.1). For our purposes an industry is defined as a group of firms producing similar products or services for the same market, for example bicycle manufacturers serving the European market. Porter’s approach concentrates on the competitive forces operating in the industry, the outcome of the analysis being an assessment of the nature of competition in the industry. The real benefit of this approach is that it forces us to take a broader perspective of competition than would typically be the case.

Porter argues that five competitive forces operate in an industry, which together determine the nature of competition. The five forces are:

- Rivalry among existing firms
- The threat of new entrants
- The bargaining power of buyers
- The bargaining power of suppliers
- The threat from substitute products or services.

We will briefly consider each of these elements in turn.

*Rivalry among existing firms*

This refers to the intensity of competitive behaviour in the industry. Are firms continually seeking to outmanoeuvre their rivals through price cuts, new product innovations, advertising, credit deals, promotional campaigns and so on? Or is there little competitive activity, the incumbent firms being content to stick with their share of the market, none of them willing to risk upsetting the balance of the industry by, say, instigating a price war? There are a number of factors that together determine the intensity of rivalry in industry.