Wal-Mart Stores, Inc.

Teaching Note

The story of Wal-Mart's rise to dominance is a standard case on resources and capabilities and how they contribute to sustainable competitive advantage. This case works well as a first case on resources and competitive advantage. It can also be used as a case to focus on cost advantage. To some extent, Wal-Mart is more of a best practices case as opposed to one where the protagonists face a do-or-die strategic dilemma. Yet, despite their overwhelming success, Wal-Mart faces some important strategic questions, particularly around their global activities and how to allocate their resources between different store formats.

Objectives

1. Students gain experience in applying the VRIO framework, particularly issues around imitation and sustainability.
2. Students will explore issues surrounding how firms exploit existing advantages in new markets.
3. Students are introduced to challenges that firms face in developing new capabilities to take advantage of new opportunities.

Study Questions

1. What are Wal-Mart's most critical competitive advantages?
2. How did Wal-Mart develop their advantages?
3. How sustainable are Wal-Mart's advantages? What is your assessment of Wal-Mart's competitors and their ability to imitate Wal-Mart's advantages?
4. What are Wal-Mart's strategic options? To what extent do these options exploit Wal-Mart's competitive advantages?

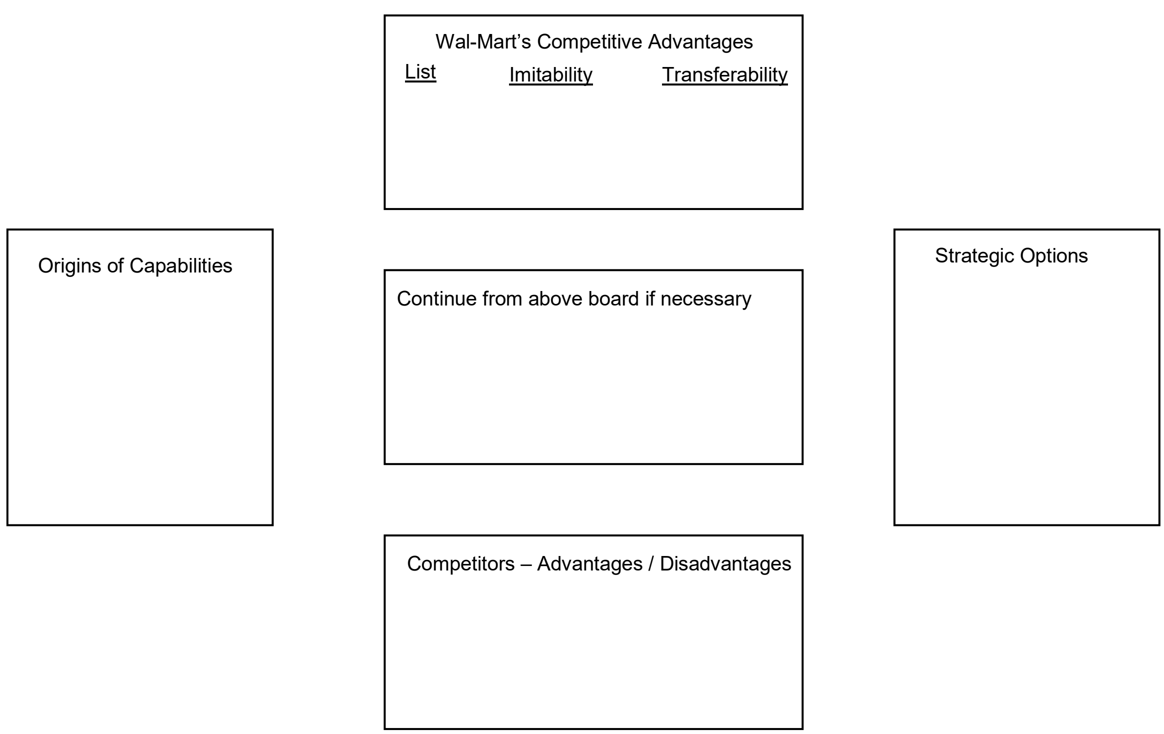
Teaching Plan

We explore four broad questions that correspond directly to the study questions above. We begin with a discussion of Wal-Mart's competitive advantages and capabilities. We then explore how Wal-Mart, despite its unlikely origins, developed these advantages. Perhaps the most crucial theme, sustainability, comes next where we explore why competitors have not fared better against the Wal-Mart juggernaut. We conclude with a discussion of what actions Wal-Mart should take going forward. This discussion helps students focus on how Wal-Mart can best exploit its advantages and on what capabilities it needs to develop moving into the future.

Why has Wal-Mart been so successful? What are its most critical competitive advantages?
I usually start by commenting that by many measures Wal-Mart has been one of the most successful companies in history and then asking, Why has Wal-Mart been so successful? I try to generate as many answers as I can. Students may tend to stop at the quick and easy answers (e.g. lower prices, bargaining power with its suppliers). It helps to focus the discussion by asking which of the advantages listed are most important. As with most discussions, I try not to take a position on this question. The goal is to help the students think a little more deeply. This discussion should generate a number of hypotheses that the instructor can list on the board (see Exhibit 1):

- buying power with suppliers
- early mover in discount retailing
- investments in information technology; early adopter of UPC, EDI, etc.
- skill in using information (forecasting, merchandising, etc.)
- distribution system with warehouses
- skills in logistics (e.g. cross-docking)
- lean management structure
- high-powered incentives of managers
- empowerment of managers
- culture that focuses on keeping costs low and continuous improvement
- Sam Walton's talent in early years
- locational advantages in small and medium size towns

Exhibit 1: Board Plan for Wal-Mart, Inc.



<u>Evolution of Capabilities and Advantages: How did Wal-Mart develop its advantages?</u>
Kmart, Target, and Wal-Mart all started in the same year. Who would have predicted that Wal-Mart would emerge the big winner out of this group? How did Wal-Mart develop its advantages against rivals with superior reputations, resources, and capital? This question helps students get at issues of how firms actually develop capabilities. Sam Walton had some foresight and insight that discount retailing might have broad appeal, but the capabilities to dominate this industry developed more out of Wal-Mart's initial location disadvantages combined with a culture of ambition and thriftiness embodied by Sam Walton.

<u>Sustainability: How sustainable are Wal-Mart's advantages? How difficult is it for competitors to imitate Wal-Mart's advantages?</u>
Another way to get at this question is to ask, If Wal-Mart is so successful, then why haven't their competitors imitated what they have done? One way to get at this question is to have students role play the CEOs of Kmart and Target and ask them to come up with a strategy to compete with Wal-Mart. It should be clear that there are some things that they can do to narrow the gap (e.g. information technology investments), but that many of Wal-Mart's resources can be very difficult and costly to imitate. I like to summarize the discussion of sustainability by going back to the list of advantages generated in question 1 and asking the students to assess how difficult each is to imitate. The summary might look something like the table in Exhibit 2.

Exhibit 2: Wal-Mart's Competitive Advantages and Difficulty of Imitation

Resource / Capability	**Difficult to Imitate**
buying power with suppliers	Target & Kmart also have significant power
early mover in discount retailing	Target & Kmart started in same year
investments in information technology; early adopter of UPC, EDI, etc.	Available on open market
skill in using information (forecasting, merchandising, etc.)	++ Difficult to observe
distribution system with warehouses	+ Costly to change system but possible
skills in logistics (e.g. cross-docking)	++ Difficult to observe; socially complex
lean management structure	+ May be difficult to do without Wal-Mart culture
high-powered incentives of managers	Probably can be imitated
empowerment of managers	+ May be costly without Wal-Mart-like culture
culture that focuses on keeping costs low and continuous improvement	++ Path dependent and socially complex
Sam Walton's talent in early years	++ Path dependent
locations in small and medium size towns	+ Many towns were not big enough for two competitors, so natural monopolies resulted; path dependent
everyday low pricing strategy	++ Very costly to imitate without dramatically improving cost structure

What are Wal-Mart's Strategic Options?
Wal-Mart has been successful, but the big question is how can it continue to grow at its historical levels with its enormous size? Wal-Mart's answer has been to shift to different store formats in the U.S. and to grow its global operations. The table in Exhibit 3 shows just how quickly Wal-Mart has moved in these directions. In only seven years, Wal-Mart has dramatically increased the number of Supercenters it operates at the same time discount stores have declined in number. The number of Sam's Clubs has increased modestly (less than 3% a year compounded). The relatively small number of Neighborhood Markets suggests that the company is still experimenting with this format. The key questions domestically are how long Supercenters can provide the kind of growth that Wal-Mart seeks. While Supercenters bring much higher revenue per store than Discount Stores, there is a risk of saturation in the relatively near future. Long term, Neighborhood Markets may constitute Wal-Mart's best chance for rapid domestic growth.

The growth outlook for international markets is more optimistic. The issues regarding international growth is to what extent Wal-Mart's advantages are transferable abroad and how much of their investment money should go to that sector (is 1/3 enough?). I find it helpful to return to the table on competitive advantages and add a third column on transferability. I use this to summarize discussion on the question, How easy is it for Wal-Mart to transfer its capabilities and advantages to international markets? The table in Exhibit 3 provides a summary of transferability of capabilities to international markets.

Exhibit 3: Transferability of Wal-Mart's Advantages and Capabilities to International Markets

Resource / Capability	Difficult to Imitate	Transferable?
buying power with suppliers	Target & Kmart also have significant power	+Int'l –global suppliers ? Int'l domestic suppliers
early mover in discount retailing	Target & Kmart started in same year	- Global competitors like Carrefour are aggressively moving into int'l markets
investments in information technology; early adopter of UPC, EDI, etc.	Available on open market	+ Can transfer but may not have a lead internationally over competitors
skill in using information (forecasting, merchandising, etc.)	++ Difficult to observe	? retail markets differ dramatically in different countries but Wal-Mart may be faster at learning
distribution system with warehouses	+ Costly to change system but possible	? lack of infrastructure in many countries may deter Wal-Mart model
skills in logistics (e.g. cross-docking)	++ Difficult to observe; socially	? May be difficult to transfer

	complex	to other locales
lean management structure	+ May be difficult to do without Wal-Mart culture	? May not work as well if Wal-Mart culture is not as entrenched
high-powered incentives of managers	Probably can be imitated	? May violate cultural norms in some countries
empowerment of managers	+ May be costly without Wal-Mart-like culture	? May be costly to transfer without Wal-Mart culture; may violate cultural norms in some countries
culture that focuses on keeping costs low and continuous improvement	++ Path dependent and socially complex	? May take time to cultivate especially where entry is through acquisition
Sam Walton's talent in early years	++ Path dependent	Not applicable
locations in small and medium size towns	+ Many towns were not big enough for two competitors, so natural monopolies resulted; path dependent	? smaller cities and towns are likely to be contested by competitors
everyday low pricing strategy	++ Very costly to imitate without dramatically improving cost structure	Transferable but need to replicate low cost advantage

Harlequin Enterprises: The MIRA Decision

Teaching Note[1]

Harlequin is the leader in series romance fiction, but it faces what appears to be a maturing market. The company is considering a proposal to enter the market in single-title fiction. The critical question is do they have the resources and capabilities to succeed in this different market? Series fiction requires a different, but perhaps overlapping, capability set than is needed in single-title books, so there is not a quick and easy answer. This is an excellent case (my personal favorite) for considering the internal capabilities of a firm.

Objectives

This case is an excellent vehicle for applying the VRIO framework. It can also be used to address fundamental questions of scope that arise with diversification.

Study Questions

1. Apply the VRIO framework to Harlequin in series romance fiction. Why has Harlequin been so successful?
   a. What is your assessment of Harlequin's value chain? How does Harlequin create and capture value?
   b. How difficult is it to imitate what Harlequin does in series fiction? Why? How likely are competitors to imitate Harlequin?
2. What is your assessment of the single-title market opportunity for Harlequin?
   a. Does Harlequin have the necessary capabilities to compete in this market?
   b. Can Harlequin create a competitive advantage in single-series fiction?
3. Should Harlequin enter the single series market?

Pre-Class Assignment

Professor White recommends having a group of students (especially males) read a Harlequin or Silhouette series romance before class. My own somewhat limited experience in this area is that it does not take long to read one of these books, and it takes even less time to get a reasonably good idea of what the books are like. The series romances are abundantly available at places like Wal-Mart, grocery stores, and used bookstores. Exhibit 1 is a useful guide to choosing which series is most appropriate for your students. Ask three or four students to read a novel before class and then report to the class.

[1] This teaching note is largely based on, R. White, "Teaching Note: Harlequin Enterprises and the MIRA Decision." The teaching note is available from Ivey Publishing (case number 8B03M07).

Teaching Plan

Application of VRIO Framework to Harlequin

I begin by asking the students who were assigned to read the series romances to report on their experience. Having students share a favorite or representative passage from the book can give fellow students a good sense of what the books are like. I will also invite other students to share their observations about romance fiction. Many students will not regard the Harlequin romances as great fiction, but some will confess to finding them entertaining. The discussion will often either raise or lead to the question, <u>Why do people buy Harlequin romances?</u> (10 minutes)
Answers will likely converge around the consistent entertainment that the books provide. Readers have a good idea of what to expect when they buy a Harlequin novel. They will get a relatively short, fast-paced romance that is readily accessible in grocery and discount stores (but, surprisingly, not many bookstores).

<u>Book publishing is generally a very competitive industry where getting the best authors is critical. Yet, Harlequin has been very successful with many different "no-name" authors. Why has Harlequin been so successful?</u>
Students will give a variety of answers. Often, the answers will be some ad hoc and students may need a more specific push to apply the VRIO model. A question like the following can get them to be more systematic.

<u>What is your assessment of Harlequin's value chain? What does Harlequin actually do? How does Harlequin create and capture value?</u>
Exhibit 3 in the case is a very useful list of Harlequin's essential activities. Clearly, when we look at different stages in fiction value chain, Harlequin does just about everything different in contrast to its single-title competitors. It may be helpful to list aspects that the students raise. Students will come up with something like the following:

- Establish editorial policy
- Standardized contracts
- Author management
- Production
- Marketing
- Distribution
- Selling

A table something like Exhibit 1 may help to establish that Harlequin has some valuable and rare capabilities. This leads to the following questions:

<u>How difficult is it to imitate what Harlequin does in series fiction? Why? How likely are competitors to imitate Harlequin?</u>
The discussion should make it clear why Harlequin has been so successful. They have some valuable capabilities that are rare and difficult to imitate. I tend to focus less on the O part of the VRIO model here, but Harlequin also has the necessary complementary resources.

Following Professor White, I think that it is helpful to have the students explore more deeply what contributes to Harlequin's success.

Which of Harlequin's capabilities is most important? If you had to choose between their editorial and author management capabilities versus their production and marketing capabilities, which would you choose?
There is no clearly right answer to this question, but the discussion will likely highlight that Harlequin has succeeded in developing valuable and difficult to imitate capabilities throughout the value chain. It also should point how necessary this range of capabilities is to success in the industry.

The MIRA Decision

A debate is an engaging way to approach this part of the case discussion. I begin by taking a vote on whether Harlequin should enter the single-title business. Then, I divide the class into smaller groups and give them 10-15 minutes to prepare to debate the question (you can skip the small group prep time, but in my experience it tends to add a lot of energy to the class and subsequent discussion). The side in favor of entering the single-title business is given three minutes to present why they would enter the business. The opposing side is given three minutes to argue why they would not go into single titles. I then let each side question the other in a less structured way. (I just try to make sure that each side has an adequate opportunity to make its arguments.)
Some of the key questions that should surface in this debate are:

- Does Harlequin have the necessary capabilities to compete in this market?
- Can Harlequin create a competitive advantage in single-series fiction?
- Can Harlequin achieve the growth that shareholders demand if they do not move beyond romance series fiction?

The first two questions are somewhat debatable. The capabilities necessary to compete in the single title market are somewhat different, particularly with respect to managing and contracting with authors. On the other hand, Harlequin's capabilities in editing and developing stories that are interesting and fast paced may translate well to the single-title business. Production, marketing, and distribution also require a different set of capabilities. The production and distribution of single-title books may require a less sophisticated set of skills, but there are significant questions around where the single titles will be sold. Harlequin may need to increase its presence in bookstores and it may need to find a way to sell single titles in its traditional channels.

The second question – Can Harlequin create a competitive advantage in single series fiction? – is a little more difficult to address with any degree of certainty. It is useful here to see if students can quantify possible advantages that Harlequin may have. Harlequin forecasts a lower selling expense and lower costs around authors and royalties is also a possibility. The question arises, however, of whether these forecasts are realistic. For example, why should Harlequin expect comparable or better results when they spend less on selling and marketing? Of course, if Harlequin chooses the entry strategy of using back listed titles to enter the market, their costs will be even lower. Even if Harlequin can develop excellent single-title fiction that consumers will buy, the organization aspect of the VRIO model comes into play with Simon & Schuster's role. Will S&S have sufficient incentive to do their part in implementing Harlequin's strategy?

The debate is likely to reveal many reasons why Harlequin should not go into single titles. Their potential competitive advantages are much more uncertain than in their present business. Some of those students who supported entering the single-title market are likely to waver. It may be helpful at this point to take another vote. Particularly, if those taking the negative side have increased, the following question is provocative:

Can Harlequin achieve the growth that shareholders demand if they do not move beyond romance series fiction?

Harlequin needs growth. The question is how to obtain it. Students may point out that the growth imperative creates an incentive for firms like Harlequin to lose their focus on a very profitable business and chase after opportunities where it potential competitive advantages are uncertain. Nevertheless, the reality is that financial markets demand sustained growth from most public companies.

Conclusion

Harlequin did enter the single-title business. It began by publishing blacklisted novels that had been written by well-known authors. Harlequin also bought out its distribution contract with S&S. Earnings increased by almost 50 percent between the time of the case and 2001. Most of the growth was attributed to the single-title business.

Generally, I will ask the students to summarize the key lessons of the case. It is a straightforward example of the VRIO framework. Harlequin's success and the value, rareness, imitability, and organization of its resources in the series business are very apparent. The case also shows the wisdom of resource-based thinking in formulating strategy. Ultimately, Harlequin's ability to see the value of their resources and capabilities in a different market was critical to sustaining profitable growth.

Exhibit 1

	Capabilities	Valuable	Rare	Difficult to Imitate	Transferable to Single Title
Editorial Policy	Clear guidelines for each series	Creates consistent, predictable product	Yes	Probably	Possibly – ability to develop and recognize popular stories
Contracting with Authors	Standardized contracts	Reduces costs	Yes	Probably not	No
Author Management	Not dependent on specific authors	Reduces costs of authors	Yes		No
Production	Consistent format; efficiency emphasis	Reduces costs	Yes	No	No
Marketing	Focus on series brand	Customers focus on brand rather than author	Yes	Yes	No
Distribution	Supermarkets Drugstores Large direct mail	Wide accessibility where women shop	Moderate	?	No
Selling	Servicing Rack placement Order regulation	Maintains consistent expectations and supply	Probably	?	No
Order Regulation / Distribution Systems	Sophisticated shipping and returns handling procedures	Reduces costs	Yes	Yes	No

True Religion Brand Jeans and the Premium Jeans Industry: Cyclical Downturn or Secular Slowdown?

Teaching Note

Synopsis and Position in the Course
*"True Religion Brand Jeans and the Premium Jeans Industry: Cyclical Downturn or Secular Slowdown"?*is an updated and revised version of the True Religion Brand Jeans and the Premium Jeans Industry case that appears in Barney & Hesterly 3ed. In the two years after the original case, some significant developments occurred both in the industry and within the firm - True Religion Brand Jeans. This teaching note highlights key changes in the sector as well as within True Religion Brand Jeans.

True Religion Brand Jeans, a startup in 2002, became a major force in the premium segment – jeans retailing for $100 or more -- of the US denim market in just three years. By 2007, the company had the second largest premium denim brand in the US behind segment pioneer Seven For All Mankind. This made True Religion far larger than jeans stalwarts Levi's, Lee, and Wrangler in the high end of the denim market. Although not the first entrant to the premium jeans segment, True Religion was successful in capitalizing on some substantial early mover advantages – namely, brand establishment in the heady days of huge industry growth, and excellent placement in key retail outlets – Nordstrom, Neiman-Marcus, and trend-setting boutiques in Los Angeles. Despite the inherent fickleness of core True Religion jeans consumers, the company's reputation for "cutting edge", "hot" jeans designs had proven difficult for competitors to overcome. The company's exceptionally strong financial performance from 2002-2006 reflected those early mover advantages.

Nevertheless, several issues plagued True Religion management. Premium denim market growth slowed in 2006, and the industry experienced a (-5%) drop in sales in 2007. In the difficult US economic environment, management's growth plans faced increasing scrutiny from investors. After an enormous drop in sales in Japan for True Religion in 2007, investor attention was focused on determining the potential for long-term above-average growth in the US market. With 7 pairs of jeans in the average American woman's closet and the ever-present possibility that fashion trends would change dramatically and make premium denim passé, investors wondered if True Religion could both survive the industry downturn and continue to grow its brand in the US. Although caught flat-footed by first-mover Seven For All Mankind from about 2000-2004, lower priced denim brands such as Levi's copied the many of the company's innovations in fit, pocket stitching, back pocket placement, fabric and finishes by 2006. The lucrative premium jeans segment accounted for an estimated 15% of women's jeans dollar sales and about 9% of total jeans industry sales. VF Corporation (Lee jeans and recently-acquired Seven For All Mankind) in particular was determined to bring premium jeans innovations to its lower-priced brands. With the economic downturn, consumers might trade down and stick with these newly improved lower-priced brands when the economy rebounded.

Seemingly in defiance of the overall weakness in the US economy, premium jeans industry sales rebounded sharply in 2008 (up an estimated 17%) from the estimated (-5%) drop off in 2007 only to fall approximately (8%) in 2009. Major department store accounts Nordstrom, Neiman-Marcus, Saks, and Bergdorf-Goodman all experienced very sharp declines in sales during 2009 as consumers cutback on expenditures. Most worryingly for the premium denim segment, the so-called "aspirational" shopper all but disappeared from the market. Aspirational shoppers – middle class consumers with luxury tastes – had household incomes between $75,000 and $150,000. Numerous press articles declared the death of the aspirational shopper and a new "bargain hunting is cool" zeitgeist that would survive after the economy rebounded. This perception was backed up by a large McKinsey & Co. consumer study in 2009 that highlighted that many Americans had traded down to less expensive products during the recession and had no intention of trading back up to premium goods after the economy recovered. Some analysts estimated that up to 70% of luxury brand sales and 50% of the growth in the luxury market was derived from so-called "aspirational" shoppers prior to the recession.

Two other developments raised questions about the long-term profitability and even the long-term survival of the premium jeans segment. First, the premium jeans market remained "soft" even as key upscale department store accounts showed good comparable store sales gains in 2010. Department store buyers kept inventory levels tight and were cautious about the prospects for upscale denim. Second, Maurice Marciano, co-founder of industry icon Guess?, announced to the world, "We are basically at the end of the denim dominance." Marciano's comments immediately raised the specter of a denim bust similar to the one in the 1980's. If consumers had lost their appetite for denim, then the premium industry's recent problems were far more significant than those arising from a mere downturn in the economy no matter how severe the downturn.

True Religion's Chairman and Founder, Jeff Lubell had publicly announced his intention to grow sales from about $173 million in 2007 to $1 billion (sales came in at $311 million in 2009). The new "professional" management team he installed during 2006 and 2007 hoped to achieve Lubell's goal by using a two-pronged strategy. The two elements of the company's strategy were 1. expansion of True Religion's brand into a global "lifestyle" brand a la Diesel and Ralph Lauren; and 2. forward vertical integration into company-owned mono-brand stores. However, failed attempts to significantly broaden the company's product mix a caused bears on the company to question the long-term viability of the True Religion brand. Only 10% of revenues were derived from sales of non-denim products at the end of 2008. By the end of 2010, True Religion's non-denim sales in <u>company-owned stores</u> had risen to 25% of retail sales. Management declined to break out non-denim sales overall, but removing the retail markup on goods sold through company-owned stores suggested that management had not been successful at goosing non-denim sales. Nevertheless, the company's forward vertical integration strategy overall had worked well. Adjusting for the retail markup in company-owned stores, revealed that management had been successful in growing the True Religion brand since opening the stores despite weak wholesale sales. International operations also showed good growth as True Religion improved the Japanese business and began to transition away from arms-length distributors to company salesforces and joint ventures with distributors in some markets. Management felt this gave the company more control over the brand and its positioning in international markets.

Nevertheless, investors were quite concerned about True Religion's growth prospects given industry trends and surprisingly disappointing company results in 3Q:10. Moreover, CEO Michael Buckley abruptly and mysteriously resigned in April 2010 only to be replaced almost immediately by industry veteran Mike Egeck (former President of Seven for All Mankind). Rock N Republic's bankruptcy and subsequent sale to Seven's corporate parent, VF Corp, raised questions about the level of rivalry in the market. While industry consolidation overall suggested some abatement in competitive pressures, investors wondered if new venture financing for up and coming brands such as J Brand, Not Your Daughter's Jeans, and Cookie by CJ Johnson would cause more intense competition among the remaining players in the market. Not Your Daughter's Jeans (NYDJ) and CJ by Cookie Johnson were attempting to segment the market, and carve out a lucrative niche by serving two previously underserved segments of the market – fashion-minded women over 40 and so-called "curvy" women.

The case leaves several questions unanswered. Will the premium denim industry resume its strong growth after the US economy improves or is the downturn in industry sales attributable to a long-term change in consumer preferences? Could the industry's decline in sales be short-lived because of a brief flirtation with other fashion clothing types by consumers? Can True Religion recover from near-term problems and achieve its longer-term goal of $1 billion in sales? Does the company have a source or sources of sustained competitive advantage?

Objectives

1. Review industry structure concepts in a rapidly maturing market subject to changes in fashion trends. Students can use both Porter's Five Forces and value chain analysis in this exercise.
2. Evaluate the sources of True Religion's competitive advantage and determine whether or not the company can sustain its advantage given the similarities between both its strategy and its products to its four largest competitors'.
3. Discuss product differentiation as a source of competitive advantage.

Study Questions

1. Is the premium jeans industry an attractive market? Develop an understanding of the industry structure and market dynamics.
2. Does True Religion enjoy a competitive advantage in the segment? If so, is its advantage sustainable? Discuss the sources of competitive advantage and use the VRIO framework to evaluate True Religion and its major competitors.

Teaching Plan

This case is designed to be used as an industry case, but works very well as a case on internal analysis also. I like to use the case to bring together concepts from Chapters 2 and 3 – analysis of the external environment, and evaluation of internal resources and capabilities. In addition, the case serves as a good discussion platform for Chapter 5's concepts on product differentiation. Students like this case, because they usually are very familiar with the product line and premium jeans in general. There are a number of productive ways to open the case discussion. Here are some suggestions:

1. Enlist the aid of 1-3 graduate students to pretend to be potential jeans entrepreneurs. The capital costs are so low that students could, in fact, start a premium denim business fairly easily. I like to read a fake "disclosure" note "mandated" by the University that says I will not benefit financially from the case discussion. I ask the students to discuss the industry dynamics with special emphasis on Porter's Five Forces and value chain analysis so that we can "help" the budding entrepreneurs. Be sure to tell the class at the end of the period that the graduate students were actors.
2. Survey the class either beforehand or at the beginning of the period on the amount each student spent on his/her last pair of jeans. Discuss why consumers perceive some jeans are worth $25 and some are worth $250 per pair. Usually, the responses will split along gender lines with women purchasing far higher priced jeans than men on average, but you are likely to find a few male students who also pay premium prices for jeans. This leads into an evaluation of the potential sources of competitive advantage and the VRIO framework or into a discussion of the bases of product differentiation.
3. Show a few slides of photos of the back pocket stitching on premium jeans and ask the students to name the brand or select the brand from a list of options. Read the brand positioning statement from some premium jeans brands' websites, and let the students figure out which brand statements match different premium labels.
4. Ask the class to vote on whether or not True Religion will be able to hit its sales goal of $1B and create a lifestyle brand. Split the class into two groups and let the groups debate the point.

Value Chain Analysis

For external analysis, you can begin either with value chain analysis or a discussion of Porter's Five Forces and industry structure. For internal analysis, it is productive to start with value chain analysis. You may ask the students to analyze the premium jeans industry's value chain using a simplified value chain (Exhibit A), McKinsey's Generic Value Chain (Exhibit B), or Porter's Generic Value Chain (Exhibit C). The basic structures of these value chains are on page 72 (simplified), page 74 (McKinsey), and page 75 (Porter) of the textbook. Closely examining the industry's value chain via the generic value chain can help students visualize the elements of Porter's Five Forces model more effectively. Once the class has laid out the elements of Porter's Five Forces, it can use either Porter's or McKinsey's generic value chain to analyze True Religion's activities which can lead into an evaluation of the company's internal resources and capabilities via the VRIO framework. Alternatively, you can skip Porter's Five Forces and concentrate on the VRIO framework. The value chain analysis using either McKinsey's Generic Value Chain or Porter's Generic Value Chain will help the students understand where True Religion Jeans derives its competitive advantages. There is enough information in the case to allow students to analyze more than one company in the industry using the value chain.

Exhibit A. Simplified Premium Blue Jeans Value Chain

Cotton Farming & Harvesting

↓

Cotton Ginning and Sales

↓

Denim Yard & Fabric Production

↓

Jeans Design & Sample Sewing

↓

Cut & Sew Operations

↓

Denim Laundries

↓

Jeans Marketing

↓

Retail Sales to Final Customers

Exhibit B. McKinsey's Generic Value Chain for Premium Jeans

Technology Development	Product Design	Manufacturing	Marketing	Distribution	Service
Denim Fabric Makers Fiber Developers Cotton Co-ops	Jeans Designers	Contract Mfgs. Cut & Sew Operators Denim Laundries	Jeans Designers Distributors Sales Agents	Retailers Company-Owned Stores	None

Exhibit C. Porter's Generic Value Chain

Primary Activities	**Raw Materials**	**Intermediate Goods**	**Finished Product**
Purchasing	Denim Fabric Makers	Contract Manufacturers	Jeans Designers
Inventory Holding	Denim Fabric Makers	Contract Manufacturers	Jeans Designers
Materials Handling	Denim Fabric Makers	Contract Manufacturers	Jeans Designers
Production	**Yarn & Fabric**	**Design**	**Jeans**
	Cone Mills	TRLG	Contract Mfg.
	Swift Denim	Seven	Contract Mfg.
	Galey & Lord	Citizens	Contract Mfg.
	Burlington	Levis	Contract & Company
	Italian	Joe's	Contract
	Japanese	Lucky	Contract
	Chinese	Rock and Republic	Contract
	Indian	Diesel	?
Warehousing	Contract Mfg.		
	Jeans Designers		
Distribution	Distributors		
	Sales Agents		
Marketing	Jeans Designers		
Sales	Nordstrom		
	Neiman Marcus		
	Macy's		
	Sak's		
	Specialty Boutiques		
	Designer Owned Stores		

Support Activities

Technology	Fabric Makers
	Fiber Companies
	Denim Laundries/Finishers
Process Improvements	Fabric Makers
	Contract Mfg.
	Denim Laundries/Finishers
Design	Jeans Designers

Porter's Five Forces – Overview

The premium jeans industry is an interesting one due to the flamboyant characters that dominate the industry as well as some interesting twists in industry threats. The top 5 firms in the segment hold an estimated 75%-80% market share - up from about 62%-65% in 2007. The industry is quite concentrated but still is quite competitive. The largest player in the market, Seven For All Mankind, has a market share of a bit less than 2x its next largest competitor. Note that premium jeans makers typically do not compete aggressively on the basis of price, but prices range from around $125 per pair to $500 per pair with some custom jeans priced at $10,000 per pair. If Seven For All Mankind were to drop its price range down from its current $165-$298 jeans, it would likely impact the ability of other premium jeans makers to keep price points intact. However, denim makers are trying to establish their positions as exclusive products for the affluent, discriminating, and fashion conscious woman or man. Price cuts by major players would likely significantly erode the cache of the products. Most premium jeans makers target young "fashionistas", but a few lines such as Seven For All Mankind and Citizens of Humanity market products that appeal to a wider age group. Seven also makes jeans for plus size women, while True Religion focuses on the very thin, very young woman. Note that major upscale lines launched both lower-priced line extensions as well as "jeggings" in the past two years to provide more attractive price points to nearly price sensitive consumers.

While the top firms hold considerable market share, the remaining 25%-30% of the market is highly fragmented. With retail mark ups of 2-2.5x wholesale on top brands and a slowdown in industry demand, the market has consolidated significantly in the past two years. Nevertheless, retailers appear happy to continue to carry many brands rather than just the top 5 or even the top 10 in the industry. In fact, upscale department stores carried about 21 different brands of premium jeans in late 2010 (almost all made by different companies). The key to understanding this unusual situation lies in consumer brand loyalty. Surveys by Cotton, Inc. show that consumers were very likely to try new premium jeans brands. In other words, consumers are always looking for the "next hot thing" or new fashion trend. Upscale retailers like Bloomingdales, Nordstrom, and Bendel's accommodate their customers by seeking out new brands and new "looks" to maintain their own images as leaders in fashion trends.

In summary, the market appears to be transitioning from a monopolistically competitive structure to an oligopoly. A few firms control a significant chunk of the market. Products are highly differentiated. However, there still are a large number of firms in the segment – with quite a bit of market share movement among below the top 3 firms. Entry costs are low, as entry requires only a jeans design, some samples, and the financial backing to contract with cut and sew operators, and denim laundries. The lack of dedicated (specific) assets due to the contract-manufacturing model suggests exit costs are low. Note, firms would lose their investments in advertising, but advertising costs tended to be low at the time the case was written. True Religion Brand Jeans advertising expense rose 4.5x from 2007-2009, but still only amounted to $5.4 million or 1.7% of sales. Successful firms can expect to establish a competitive advantage.

Summary of Porter's Five Forces

Threat	**Threat Level**	**Comments**
Rivalry	High	Low customer switching costs, slowing market demand, large number of firms, and high profits associated with larger market positions all increase rivalry.
Entry	High	High profits for industry leaders and low capital investment requirements coupled with buyers' interest in new brands encourage entry. Lured by potentially high profits, new brands entered the market even during the downturn in the economy and the industry.
Suppliers	Low	Cotton prices have skyrocketed but the input is a widely available global commodity. No one company or group of companies sets prices or controls cotton supply. Textile makers face intense global competition; contract manufacturers and denim "laundries" are plentiful; and the capabilities of suppliers are far different from those of denim designers/marketers.
Buyers	Moderate-to-High	The concentration of buyers in the department store channel and their increasing reliance on private label clothing lines for profit generation makes the threat level of buyers high. Moreover, the department store industry is highly concentrated with the top 8 firms holding 94% market share. Note end consumers do not have much individual buying power, but are quite fickle. Product differentiation helps mitigate this threat as do the extremely high markups on premium denim by the retailer. Moreover, top premium makers have forward vertically integrated in order to reduce reliance on retailers, increase order predictability and increase margins.
Substitutes	High	Premium jeans makers are selling "fashion" as well as functionality. "Fashion" could be a pair of "must have" jeans this season, and a trendy designer dress next season. Note the popularity of slacks for "casual Friday" workdays and its impact on jeans sales in the late 1980s and 1990s is a testament to the threat of substitutes in the jeans market.

The Threat of Rivalry

The threat of rivalry is high. Despite the high degree of concentration in the industry (the top 4 firms hold an estimated 75% share), rivalry is high in the premium denim market. There are several factors that increase the level of rivalry in the segment. First, the profitability of the leading companies in the segment is very attractive. True Religion Brand Jeans enjoys both high margins (operating margin of about 25% in 2009) and high returns on average assets (nearly 24% in 2009). Financial data is not available on Seven For All Mankind but it is reportedly very profitable. Moreover, there is a large difference in profitability between the top 2 companies in the segment and smaller players – suggesting there are some size advantages associated with high market shares in this category. Second, there are a large number of companies in the premium niche. Typically, each marketer sells just one brand. Lower priced jeans makers (Levi's and Lee) are attempting to move up in price point by both copying innovations made by premium labels and by improving fit through extensive consumer research – hence closing the product performance gap. Third, switching costs are low. Consumers can switch from one brand of jeans to another easily. In fact, pioneers and early adopters actively seek out the newest fashions. Cotton Inc.'s survey of premium denim buyers' brand loyalty revealed consumers are likely to prove quite fickle in this market, despite being satisfied with their latest denim brand purchase. Fourth, slowing market growth intensifies competition as firms all fight for the same customers. Market growth had already slowed prior to the recession, and then declined about (-5%) in 2007, rebounded 17% in 2008 and then fell sharply (-8%) in 2009. Up and coming brands, NYDJ and CJ by Cookie Johnson were attempting to carve out new niches in the market by offering superior fit and innovative designs for previously underserved market segments.

The Threat of Entry

The threat of entry is high. The combination of low barriers to entry coupled with the very high financial returns of industry leaders and the interest of both retailers and consumers in new, "hot" or "fresh" fashion looks and brands encourages entry into the premium jeans segment. Asset specificity is very low as the dominant model in the industry is outsourced manufacturing and finishing. High brand awareness and brand loyalty can be difficult to overcome but actual advertising dollars spent were very low at the time of the case. Design capabilities are important, but can be obtained at relatively low cost. The most difficult obstacles to overcome are lack of distribution and lack of brand awareness. However, key retail accounts seek out new brands and products in order to maintain their own brand positions as "trendsetters", as do end consumers of premium jeans. Word of mouth advertising and celebrity "buzz" were critical to the establishment of the leading brands and remains the major vehicle for brand awareness creation. Scale appears to come into play in brand awareness and distribution rather than in production or research and development. Product differentiation has not proven to be a significant barrier to entry.

Cost advantages independent of scale in managerial know-how and design capabilities do not appear to erect significant barriers to entry as both can be obtained via hiring from a large labor pool or through horizontal product diversification by large fashion houses. Obtaining the services of a design team known for its ability to accurately predict or set fashion trends over the long run would likely be costly and difficult. However, those capabilities have proven to be quite elusive for designers in the fashion industry, and may not exist. Nevertheless managerial know-how and design capabilities along with possible learning curve advantages related to understanding the desires of "fashionistas" may have contributed to the large split in profitability between the top 2 companies and all other competitors in the sector.

Threat of Suppliers

<u>Suppliers pose little threat to premium jeans companies.</u> Suppliers are strong threats when 1. a few suppliers account for a large percentage of industry supply; 2. the products suppliers sell to manufacturers (inputs) are differentiated; 3.manufacturers incur switching costs if they change suppliers; and 4. suppliers pose a credible forward vertical integration threat. US textile manufacturers face intense global competition from denim fabric manufacturers in China, and India. Moreover, producers of high quality denim in Italy and Japan supply many US premium denim makers. Overall, global denim fabric supply is ample. Capacity additions occur in large increments, which increases pricing pressure for denim fabric manufacturers as it increases the incentive for companies with new capacity to use marginal costs as their basis for pricing.

The contract cut and sew apparel industry is highly fragmented and populated by thousands of firms. According to the US Economic Census there were nearly 7,200 cut and sew apparel contractors in the US alone in 2002 (most recent data available). The four largest cut and sew apparel contractors held just 5% of the market with the eight largest firms holding only an 8% share. Although True Religion Brand Jeans relied upon on two companies for about 90% of its production of jeans as recently as 2007, the firm expanded its contracted manufacturing base to include other suppliers from 2008-2010. Many other contract cut and sew operators have the capabilities to make premium jeans to the company's specifications. The company does not have any long-term supply agreements with its manufacturing contractors so switching costs are likely to be minimal. Cotton is the most important raw material in denim jeans, but it is undifferentiated and trades on global commodity markets.

Both denim fabric makers and cut and sew operators could forward vertically integrate into jeans design and marketing. So far, most of these companies have not chosen to do so despite the attractive margins available to some premium jeans designers. This is likely due to the large difference in resources and capabilities required to move from production to branding (product differentiation). However, Mexican denim maker, Grupo Denim launched a line of premium jeans in the US market in Fall 2010. The denim manufacturer already was vertically integrated into pattern design and jeans manufacturing and finishing. The branded denim business, called Vintage Revolution, was run by industry veteran, Michael Press (formerly of Paige Premium and Earnest Sewn).

From a bargaining power standpoint, only the denim laundries appear to pose a potential threat to the premium labels. Denim laundries are not scarce, but they turn out highly differentiated products that are custom formulated or each designer. The "wash" and other fabric treatments such as the judicious application of paint, oil, and formaldehyde are major factors in creating the distinctive "look" of each designer's product. Skill levels vary widely as to specific areas of expertise among the denim laundries. Most laundries are located in Los Angeles as are many denim designers. Interestingly, Citizens of Humanity recognized the key contribution and potential for holdup of denim laundries and acquired its own laundry. The labor intense nature of the laundries and the value-added of the "finish" of the jeans mean that denim laundries capture a meaningful slice of the total input costs of premium jeans. On a total supply cost of approximately \$40-\$50 per pair, the wash and finish cost ran about \$12 with some finishing treatments running at \$25 or higher per pair. Note the move away from embellished and distressed denim to "clean and classic" reduced dependence on denim laundries somewhat.

Threat of Buyers

<u>Buyers pose a high threat to premium denim makers in the US.</u> The buyer threat level is heightened when 1. a few buyers account for a large percentage of sales; 2. the number of buyers in the industry is small; and 3. there is a credible threat of backward vertical integration by buyers. High-end department stores account for a large percentage of industry sales and those retailers have large market shares in the department store sector. For True Religion, US department store Nordstrom accounted for over 15% of sales. According to the 2002 US Economic Census (most recent data available), the department store industry is highly concentrated with the top 8 firms controlling 94% of the market. The top 4 firms hold a 66% share of the department store sector. Both factors suggest department stores have considerable potential bargaining power with premium jeans companies.

In addition, department store companies already have considerable experience in the store brand or private label business. Major upscale retailers, Saks and Nordstrom, derive 15%-17% of total revenues from store brand sales. These firms have the resources and capabilities to backward vertically integrate into premium jeans. With the economic downturn, retailers increasingly are looking to store brands for both sales growth and profit growth. Two factors reduce the threat – premium jeans have high retail markups (margins), and the products are sold on the basis of their brand positioning rather than on the basis of functionality.

Threat of Substitutes

<u>The threat level of substitutes is high</u>. The discussion of substitutes typically proves to be the most controversial with students. Some students will maintain that there is no substitute for premium jeans given consumers' enduring interest in the high-priced pants. Other students will argue there are many substitutes for jeans based upon the functionality of the product and the availability of other products that can provide the same functionality. This is an opportunity to encourage the students to think about True

Religion's, Seven For All Mankind's, Citizens of Humanity, and Rock and Republic's "value proposition" to the end consumer. What are these companies selling – jeans, comfortable and good -looking pants, or something else? You'll probably have to remind the students that lower-priced jeans are not substitutes as they are in the same product category as premium denim. Those lines such as Levi's are direct, lower-priced competitors.

In my view, substitutes are the single largest threat to both the premium jeans industry and to individual denim designers like True Religion. This is the issue that most worries investors in True Religion - a major shift in fashion trends. True Religion, Rock and Republic and other denim design companies that emphasize "trendiness", and "the latest hot styles" are especially vulnerable to a shift in consumer preference to other high fashion categories. Seven and Citizens have broadened their appeal in order to attempt to become wardrobe staples with some success. Nevertheless, when fashion trends change, all denim design companies will be hurt. Marciano's comment about coming to the end of denim dominance suggests major industry players thought that fashion trends had already shifted away from jeans in late 2010.

The companies are selling "fashion" and image as much or more than they are selling functionality. Of course without the fit and comfort of a well-designed product, none of the premium denim designers would survive for long. Product functionality will not likely prove to be enough to save many industry players when high-end denim consumers have had enough of the product. Substitutes could include premium-priced designer dresses and slacks, leather pants, and shorts. Consumers also could decide to spend more money on accessories like premium-priced bags, gloves, scarves, and shoes or expensive costume jewelry.

Key Elements of True Religion's Strategy – 2009 & 2010

The major question facing True Religion management was how to continue the company's strong growth over the next five years. Jeff Lubell – Chairman and CEO, and Michael Buckley- President devised a three-pronged plan to move the company forward in 2007. First, True Religion would try to establish itself as a "lifestyle brand" via product diversification. Product diversification moves would come through company-launched line extensions into categories closely related to denim jeans as well as licensing arrangements for products in categories like perfume, bikini's, and shoes. Second, True Religion would forward vertically integrate into company-owned mono-brand stores and outlets. Forward vertical integration carried three potential advantages – margin enhancement, and reinforcement of the product diversification plan. Management expected so-called 4-wall contribution to come in at about 40% compared to the company's 27% operating margin. True Religion had difficulty getting key retail accounts to carry its non-denim items. Management felt that company-owned stores would be showcases for the entire product line and help to convince skeptical retailers that the whole line had consumer draw. Ownership of outlet stores helped management retain control over "seconds" and obsolete product. Third, True Religion would continue to pursue international expansion. As of late 2010, the company had not changed the basic elements of its strategy. Note that True Religion was more vertically integrated in 2010 than in 2007 as it moved to bring the sales function within company boundaries both in the US market and in some international markets.

Overall, it appeared that True Religion's forward vertical integration into retail stores had worked. The company was successful in generating increased total True Religion brand sales within the US market even though wholesale sales were weak in 2009. Margins for the retail side (or consumer direct segment) came in at or above plan. Nevertheless, the decline in wholesale sales and lack of success in expansion into non-denim items as well as the abrupt departure of Michael Buckley in April 2010, meant the company's strategy had not been completely validated by the marketplace.

True Religion Brand Jeans and Sources of Competitive Advantage

I use the VRIO framework to evaluate potential sources of competitive advantage for True Religion. The industry/external analysis especially the value chain analysis will help students understand the company's business model as well as the dominant model in the industry. Thinking about the key components of the value chain will help students isolate some resources and capabilities that contribute to True Religion's success.

Summary of VRIO Analysis of True Religion Brand Jeans

Resource/Capability	Valuable	Rare	Imperfectly Imitable	Organized to Leverage Assets
Product Design	Yes	Somewhat	No	Yes
Fashion Trend Forecasting	Yes	Yes	Yes	Yes
Brand Equity	Yes	Somewhat	Yes	Yes
Financial Position	Yes	Yes	No	Yes
Distribution	Yes	Somewhat	No	Yes
Licensing Arrangements	Yes	Somewhat	No	Yes
Company-Owned Stores	Yes	Somewhat	No	Yes
Lifestyle Brand Strategy	Yes	No		
Relationships with Contract Manufacturers	Yes	No		

Implications of VRIO Analysis on True Religion

A VRIO analysis of Seven For All Mankind, and Citizens of Humanity would likely be identical to the one shown above for True Religion brand jeans. All three firms are pursuing similar strategies and have similar resources and capabilities. There does not appear to be any one resource or capability that gives True Religion a competitive advantage rather it is some combination of resources/capabilities that is not observable (causally ambiguous) from outside the company. It is worth noting that the three top firms entered the premium denim market early in the product life cycle. Timing seems to have played a major role in establishing these brands as the top brands in the US premium denim market.

Pfizer and the Challenges of the Global Pharmaceutical Industry
Teaching Note

Overview and Objectives

The Pfizer case provides an introduction to external analysis. The case highlights the pharmaceutical industry, which has enjoyed extraordinary long-run profitability. Students have the opportunity to use the tools in Chapter 2 to understand why the industry has enjoyed such success. The case also demonstrates how broad changes in broad environmental factors (i.e. demographics, technology, culture, etc.) have an impact on industry competition. The case is not especially complex, so it is not overwhelming as a first case.

Study and Discussion Questions

1. Why has the pharmaceutical industry been so successful historically?
2. What is your assessment of the pharmaceutical industry at the time of the case? How is competition changing? What factors are driving the changes?
3. What will competition in pharmaceuticals look like in 10 years?
4. What is your assessment of Pfizer's position in the industry? What are the keys to success in the industry?
5. What recommendations would you make to Kindler?

Discussion and Analysis

1. The Historical Success of the Pharmaceutical Industry

My goal in this part of the discussion is to lead students toward a systematic application of concepts. I begin the discussion by asking: **Why has the pharmaceutical industry been so successful historically?** Typically, students will not have developed the habit of systematically applying frameworks to analyze cases unless they have had other case classes. Many will have one or two ad hoc observations rather than a systematic analysis of the industry. Many will not have considered more than a very few of the variables raised in chapter 2. Instead, students will have focused on a few salient issues from the case. So, in this discussion, it is important to push them. One way to do this is to generalize their responses and ask if the generalization is true. For example, a student may respond to the question above by observing that pharmaceutical firms are unusually successful because they satisfy a fundamental human need. I will respond by saying, so companies that provide products that satisfy a basic human need will be more successful? I might point out that air solves what is an even more basic or pervasive human need, yet we see few firms making money from air. Depending on how systematic the class is, the instructor may have to ask a more "meta-analytical" question about how we should approach such a question such as, **What variables would we look at if we wanted to determine the likelihood of an industry's**

success? The purposes of such a question is to help students start to see the frameworks in chapter 2 (SCP or five forces) as a way to answer questions about the success or attractiveness of the industry.

2. Assessment of the Pharmaceutical Industry

Once students have grasped the importance of using a framework, I then start to probe on each of the five forces.

How important are entry barriers in the pharmaceutical industry? What would it take to start a new firm that could compete against industry leaders?

As profitable as the industry is, one would think that it might invite entry from firms who want to enjoy such profits. However, barriers to entry are enormous for any who would want to start a pharmaceutical firm. Exhibit 6 tells us that it takes over 12 years just to go through the pre-clinical and clinical testing. By 2000, the average R&D costs for a new drug were approaching a billion dollars. The intensive investment in sales forces by leading firms indicates that for many applications, sales reps play an important role. Building a sales force, however, requires an enormous investment in fixed costs.

What about substitutes? What are the alternatives to pharmaceutical products?

Of course, the answer to this question depends on the malady involved. One can look on a website like Mayoclinic.com website to see that many conditions have natural or home remedies. However, a great many do not. Prescription drugs are the only solution likely to be prescribed by many physicians for many ailments. It is possible that natural and home remedies are growing in popularity, but for many applications at least, there are no viable substitutes to prescription drugs.

How intense is competitive rivalry in the pharmaceutical industry?

Students will have a tendency to see most industries as characterized by intense competition. At best, this is not a very insightful observation. At worst, it is simply wrong. One way to make the discussion more meaningful here is to ask, **How do pharmaceutical firms compete?** There is not a really short answer to this question. Perhaps most importantly, though, pharma firms compete for new patented formulations where they may enjoy a monopoly that will last for approximately two hours. Aggressive price competition is not very common for prescription drugs that enjoy patent protection. Competition on price becomes more intense once a patent expires. So, the degree of rivalry is largely a function of whether a drug enjoys patent protection.

How much of an impact to bargaining power of buyers and suppliers have on industry competition? There is not much in the case to suggest that bargaining power of suppliers is much of an issue, at least broadly in the industry. There may be some drugs where it is an issue, but for most, it is probably not a threat. The bargaining power of buyers is a different story. Governments and large insurance companies are getting much more aggressive in demanding lower prices from pharmaceutical companies. This is clearly one of the greatest threats to industry profitability. It is, however, much greater in countries where buying power is more centralized.

Summary of Five Forces Analysis for the Past in the Industry

When one summarizes the five forces it is easy to see why the pharmaceutical industry has enjoyed such high profitability. Entry barriers are extraordinarily high. Patents play a particularly prominent role in curtailing the intensity of competition. The threat of substitutes is low to non-existent for many illnesses. Supplier bargaining power poses little threat for most drugs. Buyer power is a bit more problematic than the other forces, but consumers and doctors in the U.S. have been fragmented. Other countries vary in how decentralized buying decisions are, and for some, buyer power is quite high.

What is Changing in the Industry?

This is a useful place to use an analogy that Clayton Christensen has used. Wayne Gretzky was once asked how he differed from other hockey players. He said, essentially, that the difference was that he skated to where the puck was going to be while other players skated to where the puck was. I point out that we have completed the relatively easy task of determining where the money was. Now, we need to explore how the industry will change and consider where the money will be in the future. My goal in this discussion will be to fill out a table on the board that may look something like the following:

Threat of Entry	Past	Present/Future
Threat of entry	Low	Low
Threat of substitutes	Low	Low
Threat of rivalry	Low	Increasing
Threat of supplier power	Low	Low
Threat of Buyer power	Low	Increasing

I get at the issues above by asking, **What is changing? Why is it changing?** Students should see fairly quickly that at least a couple of forces are changing. Rivalry is becoming more of an issue as companies enjoy shorter periods where their market positions are uncontested following the introduction of a breakthrough drug. Also, competition over generics appears to be getting more intense. As for buyer power, the beginning of the case makes it clear that pricing pressure from governments is increasing dramatically.

What is driving these industry changes?

This may be a difficult question for students to answer, particularly those who are analyzing their first case. To help them think more deeply, I might follow up a response with a few why questions. An example of what I would do might go something like the following:

Instructor:	Why are governments exerting more pressure on pricing now?
Student:	Most countries are trying to lower the rate of increase in health care costs.
Instructor:	Presumably, countries have always cared about health care expenditures. Why do they seem to care more now?
Student:	Costs are getting to be unsustainably high.

Instructors might vary in how far they want to push the discussion of root causes of why governments are becoming so much more vigilant about health care costs. I like to push fairly hard because the discussion can show to the students how changes in broad environmental forces – demography, culture, societal expectations, technology, etc. -- can affect industry structure and ultimately a firm's competitive position. Possible causes of changes in the pharmaceutical industry might start with demographic changes. Aging populations in western nations create more demand for health care products and services and drugs are no exception. Where countries have some type of national health care or insurance, aging populations put more pressure on the system, particularly if fewer younger people are paying into the system. Shifts in cultural expectations also play an important role. Increasingly, health care is viewed as a fundamental right. On the flip side, pharmaceutical companies are held in low regard. They are, in the eyes of the public, comparable to big tobacco and oil firms. (Just think of how pharmaceutical firms are depicted in movies, e.g. *The Fugitive* or *Planet of the Apes*.) Some students might find it remarkable that an industry that produces life-enhancing and even life-saving drugs might be held in such disrepute. This point can make for an interesting discussion on the role of societal expectations.

3. Forecast of Industry Structure

Forecasting the future of an industry can be a humbling exercise, but I find it a helpful way to get students to realize that industries change. This is, of course, an obvious point, but students will often tend to focus on what the industry is like today and not think very hard about how an industry will evolve. So, begin this section of the discussion by asking, **What will competition in the pharmaceutical industry look like in 10 years?** It may be helpful to ask them what is likely to change and how those changes will play out. So, the instructor might ask, **How is the bargaining power of buyers likely to change?** (become more intense) **How is the threat of entry likely to change?** (the scale needed for approval (e.g. FDA) of drugs is likely to continue increasing; one could argue that the scale needed for sales forces might decrease. As medical decision making gets more centralized, the need to have reps contact individual doctors may decrease. **What will happen to rivalry?** One could argue that it will tend to increase as proprietary positions for an application become more difficult to establish and sustain. I may ask if anyone believes that supplier power and substitutes are likely to change to complete the discussion. **If buyer power, rivalry, and economies of scale are likely to increase, what are the implications for industry structure?** This is an entirely speculative discussion and the important thing is to get students to consider what changes might occur and why. I tend to think that firms will want to consolidate more to achieve more balance in bargaining power and to moderate the threat of rivalry. However, governments will likely to try to oppose such consolidation where possible.

4. Pfizer's Position in the Industry

My objectives are focused more on the industry than the firm, and there is not much firm level data in the case. Nevertheless, it is useful to spend some time on Pfizer's position in the industry. **What is your assessment of Pfizer's position in the industry?** As Exhibit 12 shows, Pfizer is the largest of the pharma companies. With over $46 billion in revenue it is more than 20 percent larger than the second largest, GlaxoSmithKline. Yet, of the firms listed in the Exhibit, only Merck has a slower growth rate.

What are the keys to success in the pharmaceutical industry? Firms must be able to discover blockbuster drugs, get them through the regulatory approval process, and then promote them through sales forces. All indications are that Pfizer continues to excel at sales, but it is not clear that they are still able to get blockbuster drugs to the market (even Lipitor, their most successful drug, was discovered by Warner-Lambert). Growing at the industry average of 8.8 percent would require Pfizer to find more than $4 billion in new sales.

What do you think of Kindler's actions so far to help Pfizer? Kindler has done some downsizing and restructuring. It is interesting to note that the stock market responded poorly to the announcement of these changes. It is not clear how these changes will address Pfizer's most fundamental need to find new high-growth drugs. It is possible that there is some magic in the re-organization of research, but the closing of the five research centers also suggests that this was a cost cutting move. No explanation is given for why the changes will produce better research.

Key Success Factors	Pfizer	Kindler's Actions
Discovery of Blockbuster drugs	Lagging performance	Reorganization of research or just cost cutting
Steering drugs through approval	Have the resources but lack the promising drugs in their pipeline	
Skilled salesforce to promote products		Dramatic cuts in salesforce

5. Recommendations

Given how thin the case is on firm-level data, I don't spend a lot of time on recommendations. The analysis above, however, suggests that Pfizer has some strengths that it may want to build on – namely, its sales force – and a weakness that it must address: its inability to produce new blockbuster drugs at a fast enough rate. Thus, it may want to focus on alliances and mergers with companies that have promising portfolios of drugs but weaknesses in their sales forces. Pfizer has indeed tried this strategy but with only modest success. It is not easy to replicate the success of drugs like Lipitor and Viagra and find $4+ billion in sales a year. The other option is to address their approach to research. It is not clear that closing 5 locations is a way to induce researchers to be more creative. Kindle's dismissal at the end of 2010 suggests that his cost-cutting and re-organization strategy did not remedy their fundamental problems.