Strategic Group Analysis

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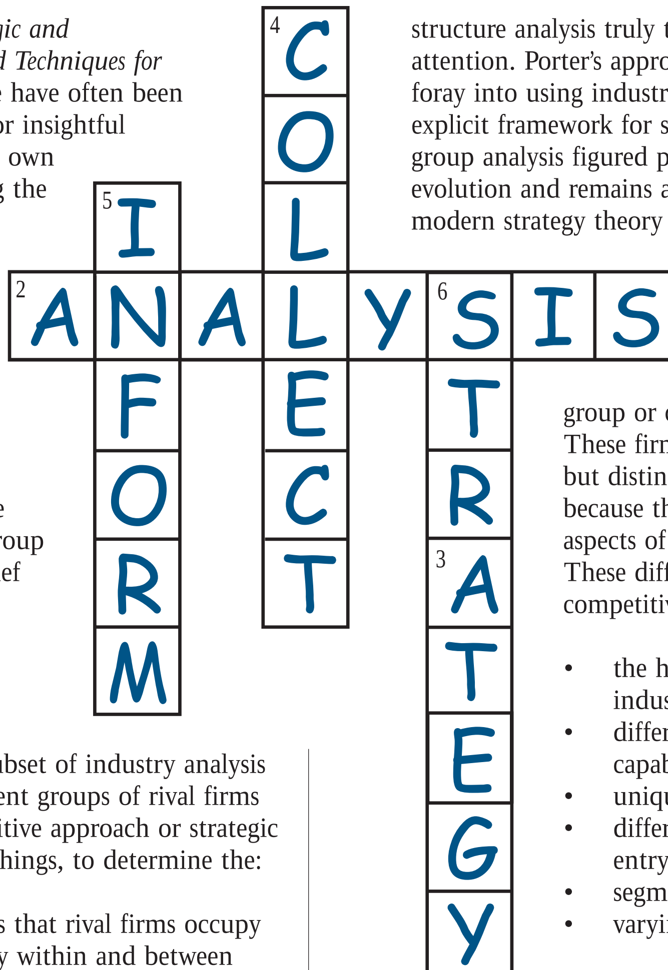
Since writing our book *Strategic and Competitive Analysis – Methods and Techniques for Analyzing Business Competition*, we have often been asked to identify the most useful or insightful models for CI. Each model has its own strengths and weaknesses: selecting the most useful or most insightful technique is always highly dependent on the strategic issue at hand.

However, among the vast number of techniques available, many are either unknown to most analysts and CI professionals or under-utilized, and yet they can provide great insight. One of these analytical techniques is strategic group analysis. This article provides a brief overview of this technique as a reminder of its value and use.



BACKGROUND

Strategic group analysis is a subset of industry analysis that looks specifically at the different groups of rival firms clustered around a similar competitive approach or strategic position. It is used, among other things, to determine the:

- different competitive positions that rival firms occupy
- intensity of competitive rivalry within and between industry groups
- profit potential of the various strategic groups in an industry
- implications for the competitive position of the firm under analysis.

While the concept of strategic group analysis dates back to the early 1970s, it was not until 1980, with the publication of Porter's seminal work *Competitive Strategy: Techniques for Analyzing Industries and Competitors,* that industry structure analysis truly tweaked management's attention. Porter's approach was the first popular foray into using industrial economic theory as an explicit framework for strategic analysis. Strategic group analysis figured prominently in this theoretical evolution and remains an important component of modern strategy theory and practice.

STRATEGIC RATIONALE

A strategic group is a group or cluster of firms in an industry. These firms are similar to each other but distinct from other industry groups because they differ in one or more key aspects of their competitive strategy. These differences may be a function of competitive variables such as:

- the historical evolution of the industry
- different resources and capabilities across firms
- unique goals
- different chronological points of entry
- segmentation
- varying risk profiles.

This far from exclusive list of strategically relevant variables distinguishes differences between groups and identifies similarities within groups.

Strategic group analysis plays an important role in industry analysis because it explicitly addresses a key force in Porter's industry analysis framework – competitive rivalry – and how that force both impacts and is impacted by the other four forces. It forms the analytical link between industry structure and the individual firm.

The five competitive forces often have disproportionate impacts on the profitability across strategic groups and, by association, on firms within each strategic group.

1. Threat of entry

Barriers to entry define both the boundaries and structure of a strategic group within an industry. Common barriers include superior cost structures, economies of scale or learning, product/service attribute differentiation, switching costs, distribution access, vertical or horizontal diversification, capital intensity, proprietary technology, and favorable sociopolitical factors.

However, these barriers mutate over time. For example, innovation is a key to dislodging established barriers because it can radically change industry structure. The optimal strategic focus for a firm attempting to redefine competition inside its existing strategic group is to jump to another strategic group or define a new strategic group.

2. Internal rivalry

Three factors determine the intensity of rivalry between strategic groups:

1. number of industry groups and their market share distribution
2. strategic distance between groups: the magnitude of strategic differences
3. market interdependence of groups: market segmentation overlap and product/service differentiation.

A directly proportional relationship exists between each of these three factors and rivalry. For example, strategic groups (who by definition are pursuing different business strategies) may target the same customer segment. The resulting clash for customer share increases rivalry between the groups.

3. Bargaining power of buyers and suppliers

Strategic groups can influence suppliers' and buyers' bargaining power in two separate ways:

1. If the strategic groups within an industry source from the same set or type of suppliers and sell to the same customer segment, the only differentiating feature between groups will be their strategies.

2. When strategic groups source from different types of suppliers and sell to different customer segments, bargaining strength could be a factor of the strategic groups' differing strategies and types of buyers and suppliers, or a combination of both.

4. Threat of substitution

The distinct strategies between strategic groups place emphasis on different parts of the industry's value chain. If the links in the value chain that are the source of a strategic groups' competitive advantage are threatened by substitutes, the group is at risk of lower profitability or worse, displacement.

COMPETITIVE STRUCTURE

The Five Forces jointly determine the profitability of the industry, the strategic groups in the industry, and individual firms within the strategic groups. Porter [1980] further suggests four factors that influence the group's competitive structure:

1. intensity of internal rivalry between firms in the same group
2. scale effects
3. cost of entry into the strategic group
4. organizational capabilities to implement the firm's chosen strategy.

The analyst's essential task is to best position the firm's resources and capabilities to capitalize on opportunities and also defend against or move away from threats within the competitive environment. Selecting the most attractive industry group in which to compete is an essential component of this process.

STRENGTHS

Strategic group analysis' primary strength is its comprehensiveness. It encompasses a wide array of conceivable variables for use in conducting an environmental analysis. Strategic group analysis offers several layers of increasingly finer analytical procedures for making the link from broad industry structure to firm-specific strategic implications.

Unless the differences between industry structure as evidenced by strategic groups are distinguished first, average comparisons across an industry can be meaningless at best and misleading at worst. Strategic group analysis often results in more accurate strategic analysis than the more traditional approaches to product/market segmentation and stereotypical definitions of strategic business units.

The identification of strategic opportunities and risks associated with industry evolution is also very helpful for dealing with change. This model encourages the analyst to look across the entire spectrum of groups to find innovative pathways of least resistance or, ideally, to build new pathways through innovation.

WEAKNESSES

Strategic group analysis provides little guidance on implementation and gives short shrift to the internal organizational capabilities needed for successful implementation of the chosen strategies. Supplementing the technique with value chain analysis compensates for this weakness, and was one of the reasons Porter subsequently developed value chain analysis.

Strategic group analysis does not explicitly incorporate the importance of government and social issues as a separate variable on the competitive dimension. It also assumes that firms have cognitive and learning abilities, for which some firms display more competence in than others.

The application of strategic group analysis depends on identifying the strategically important dimensions of competition. Inaccurate identification and inappropriate weighting of these variables skew the correct identification of strategic groups, leading to ineffective strategic recommendations.

One problem is accessing profitability data for the companies in the strategic groups, whether they are non-public firms or aggregated financial results for diversified firms. The best solution for this challenge is to use public profitability data sources and supplement them with comparative cost analysis and disaggregated financial ratio analysis. Then map the different groups on a graph that incorporates the two strongest strategic variables that differentiate them.

In-depth industry knowledge and iterative learning are the two most important ingredients for effectively choosing the best two dimensions for each map axis. Often, more than one map is constructed if more than two competitive variables are deemed significant. In addition, the analyst may discover that some groups overlap while other groups cannot be defined by the model because they do not exhibit any type of coherent strategy or they radically oscillate between strategic extremes.

APPLYING STRATEGIC GROUP ANALYSIS

The process for applying strategic group analysis has five steps (See figure 1).

1. Analyze industry structure

First, complete a Five Forces industry analysis. [See Fleisher/Bensoussan 2003, Chapter 6 for an explanation of how to undertake an industry analysis.] This analysis will include a study of:

- threat of new entrants
- bargaining power of suppliers
- threat of substitution
- bargaining power of buyers
- degree of internal rivalry.

Once this is completed, the analyst can refine the identification of the unique factors of membership in a certain strategic group relative to the competitive position of other member firms.

Second, identify all of the major competitors in the industry based on competitive variables. All of the significant participants within an industry must be identified based on the various strategic variables in the industry. (See Table 1: Porter's Key Variables.) Porter's list is not all-inclusive. Work by Rumelt [1981], Gailbraith and Schendel [1983], Ackoff [1970], Dill [1958], and Aldrich [1979] suggest additional elements of the competitive dimension. However, this serves as a useful launch pad for brainstorming.

2. Map the strategic groups

Separate the list of significant competitors into strategic groups, those firms with similar strategies and competitive positions. Interviews with top managers and functional experts provide the best sources of information regarding alternative strategies, key success factors, assets and skills, and barriers to entry. In this area you may want to look at:

- mobility barriers
- bargaining power
- threat of substitution
- rivalry from other strategic groups.

TABLE 1: KEY VARIABLES FOR DEFINING STRATEGIC GROUPS

- Specialization
- Cost position
- Brand identification
- Service
- Push vs. pull
- Price policy
- Channel selection
- Leverage
- Product quality
- Relationship with parent company
- Technological leadership
- Relationship to home and host
- Vertical integration government

3. Gauge the strength of barriers between groups.

First, identify the factors that prevent firms in one strategic group from competing with firms in another group. McGee and Howard [1986] suggest the following three classifications of barriers (this is by no means all-inclusive):

- market-related strategies: product line, market segmentation, distribution channels
- industry supply characteristics: economies of scale, manufacturing processes, R&D
- firm characteristics: management skills, diversification, organizational structure.

Second, assess the strength of bargaining power between groups and industry buyers/suppliers. Identify the relative importance of the two sources of bargaining power between strategic groups: common suppliers and buyers, and different suppliers and buyers.

Third, determine the threat of substitutes between groups. Analyze the different value chain links that the different strategic groups compete around to determine each group's vulnerability to the threat of substitutes.

Fourth, evaluate the intensity of internal rivalry between groups. Determine the relative impact of the four factors that determine group rivalry:

- intensity of internal rivalry between firms in the same group
- scale effects
- costs of entry into the strategic group, including both superior resources and timing
- organizational capabilities to implement the firm's chosen strategy.

Fifth, undertake a Five Forces analysis of the strategic groups. Integrate the analysis of steps 1 through 3 to determine each strategic group's relative competitive positions, the intensity of their mutual dependence, and the potential for industry volatility based on:

- strength of barriers between groups
- strength of bargaining power between groups and industry buyers and suppliers
- threat of substitutes between groups
- intensity of internal rivalry between groups.

4. Understand firm's strategy vis a vis strategic groups' interaction.

Select the firm's membership in the optimal strategic group. Mentally overlay the Five Forces model of the strategic groups on the firm's strengths and weaknesses. Identify the strategic group that presents the greatest opportunity to exploit the firm's strengths and minimize the firm's weaknesses, given the firm's existing strategy.

5. Identify appropriate strategic responses.

Consider the industry's evolution and analyze the strategic opportunities and threats that accompany radical industry change. Depending on the firm's available resources, organizational capabilities, and risk preferences, two different types of strategic intent can be pursued to meet the challenge of industry evolution:

- mildly proactive — coping strategy
- intensely proactive — shape-shifter strategy.

These responses could include:

- create a new strategic group
- move to a better strategic group
- strengthen the existing group or the firm's position within that group
- move to a new group and strengthen that group.

Keep a cautious eye on group identity dysfunction. The analyst should watch for any signs of common dangers resulting from strong identity with a strategic group, such as reduced flexibility, strategic myopia, and sub-optimizing behavior.

In conclusion, strategic group analysis is quite valuable as a descriptive tool and contributes to an understanding of competitive dynamics, industry evolution and structure. Due to the highly qualitative inputs and reliance on the analyst's judgments, accuracy and objectivity will decline. As with most good analytical tools there are no short cuts and this does take some effort to deliver.

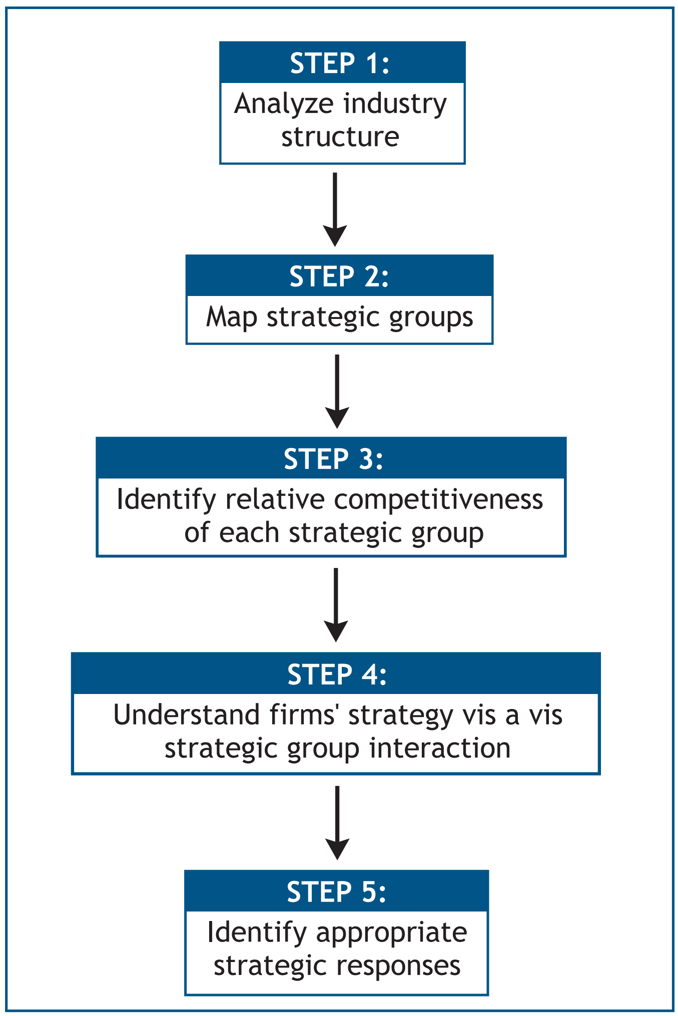


Figure 1: Strategic Group Analysis

FAROUT SUMMARY: STRATEGIC GROUP ANALYSIS

Future orientation

High. An excellent tool for scenario analysis and industry evolution analysis.

Accuracy

Low to medium. Highly qualitative inputs, statistically non-verifiable, accuracy will decline if the analysis isn't part of a broader industry analysis.

Resource efficiency

Medium. Input from various data sources both primary and secondary may be necessary to achieve correct identification of multiple variables.

Objectivity

Medium. Significant inputs are subjective and rely on the analyst's judgment; objectivity can be reduced by iteration; group identity effects can drastically reduce objectivity if left unchecked.

Usefulness

High. Can be used for both current and dynamic strategy formulation.

Timeliness

Medium. Strategic group analysis can be conducted in a relatively short period of time.

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[**Editor's Note:** this article is based on Babette Bensoussan's and Craig Fleisher's book, *Strategic and Competitive Analysis: methods and techniques for analyzing business competition*, from Prentice Hall, 2003. The book comprehensively examines 24 of the techniques involved in analyzing business and competitive data and information including environmental analysis, industry analysis, competitor analysis, and temporal analysis models. It helps business analysts and decision-makers draw effective conclusions from limited data and put together information that does not often fit together at first glance. The book features conceptual ideas about business and competitive analysis along with a strong bias toward practical application.]