Competitive Strategy

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The “Why” of industry analysis

In 2016, the global fast food industry had a revenue of $570.000 million (Franchise, 2017). Within this industry I have chosen to focus on the US, because they account for 44% of the global fast food market value (MarketLine, 2017) and players such as McDonald’s, Domino’s Pizza and Kentucky Fried Chicken, who eventually turned out to become billion-dollar global businesses, have their origins here.

When looking at profitability of the US industries, data from Standard & Poor show that the average industry has a *return on capital investment* of 14,9% (Porter, 2008, p. 28). A long-term industry analysis from McKinsey show, that the ROIC for the food and beverages industry are below that average with approximately 13% (McKinsey, 2017).

While these numbers indicate what the size and profitability of the fast food industry are, they do not explain *why* this is the case. Numerous factors come into play when formulating strategy, and a solid foundation of industry analysis is needed to understand these industry developments.

In the following I will assess the profitability of the fast food industry using the *5 Forces framework* (Porter, 2007).

Supplier power

The analysis of suppliers bargaining power cares about the *input market*, where a firm buys raw materials, components or labor services (Grant, 2010: 75). This market transaction takes place within the industry, and the suppliers’ bargain power refers to the ability to set higher prices on goods and services sold.

In the fast food industry, companies encounter these bargaining situations, when for instance buying food, maintenance services or restaurant equipment. Generally speaking, if there is competition amongst different suppliers it decreases the overall bargaining power, because companies of the fast food industry can choose multiple vendors for the same product. In the US two major suppliers sits on the supply side, namely Sysco and Foodservice Inc. (Marketline, 2017). Powerful suppliers limit the economic surplus of an industry, as they can charge higher prices and even offer lower quality of service (Lecture, July 6th). Although this suggests a duopoly, which makes input fairly concentrated, I would argue that the diversity of fast food products demanded must result in several suppliers. It might be suggested that the larger fast food chains are more dependent of these two suppliers, as they purchase more, but McDonald’s for instance has several smaller suppliers for fish or beef (McDonalds, 2017). This makes it easier for buyers to compare prices, which decreases bargaining power of suppliers.

Additionally, the size and independence of the suppliers affects their bargaining power. Sysco and FoodService Inc. have buyers in the foodservice sector (Marketline, 2017), which makes them more independent and financially stable. On the other hand, there is low risk of the suppliers integrating forward, becoming a direct competitor, because it for instance takes resources such as human capital to deliver the fast food service.

We also need to consider providers of workforce. Grant (2010: 77) argues, that labor unions are an important source of supplier power in this regard. The higher percentage of unionized employers, the higher is the bargaining power. Labor unions in the US have little power, however (Investopedia, 2017). In the fast food industry labor is intensive, as wages makes up 25-30% of operating cost (MarketLine). Although, this means that minimum wage legislation can be a factor of bargain power in some industries, the fast food industry in the US is dominated by relatively low wages, as 50% of front-line fast food employees for instance rely on public assistance programs (Franchise, 2017). This means that the workforce, as a supplier of labor, has little bargaining power.

Weak threat to industry profitability
The threat of suppliers' bargain power is viewed as weak force due to the large amount of different suppliers and little to no bargain power of unionized labor.

Buyer power

In the market for *outputs*, companies sell their services and goods to customers (Grant, 2010: 75). In our case, customers are understood as consumers of fast good. A powerful buyer will expect lower prices of products. We can now assess the relative strength these buyers.

A main source of buyer power is the low switching cost, because consumers' choice of fast food depends on personal preferences, and the cost associated with selecting chicken at KFC over meet at Burger King are not very high. Furthermore, there are numerous different fast food outlets to choose from, which grants the buyer with even more power (Gregory, 2017).

In this industry consumers are also relatively sensible to price, because the they are familiar with the different price ranges (Marketline, 2017). That being said, fast food is not something buyers need to have, and this makes them more independent. A main factor in regards to the low switching costs and a large number of fast food outlets, is the general investment in brand building (Marketline, 2017). This is a vital factor, that is able to reduce the bargaining power of the consumers, as it drives brand value and will make consumers more loyal towards a brand.

The risk of backwards integrating from the buyer is low, because it for instance takes financial capabilities for an individual to open a fast food joint.

High threat to industry profitability
The buyer power is viewed as high, because of the low switching cost and the large amount of fast food outlets in the industry.

Threat of new entrants

If the returns on capital investment are greater than the cost of capital in an industry, it will attract a lot of new entrants (Grant, 2010: 71). This is bad for incumbent market share, because there a more to share and this decreases profitability over time.

Barriers to entry in the global fast food market are relatively low, as it does not require large capital outlet (Marketline, 2017). This makes it relatively easy for new companies to enter the market. As mentioned before, the large amount of suppliers makes it easier for new entrants to access distribution. The large players can, however, reduce cost through franchising, which means that new players might struggle to compete with incumbent firms. The franchising model of the larger fast food chains effects business expansion for the brand, full control of the business through dictated terms of the franchise and a steady flow of income in the form of franchise fees and royalty payments (Investopedia, 2017). Because new entrants' brands are unknown and the cost associated with advertising and developing the brand are high, this limits the threat of new entrants to the well-established incumbents. Furthermore, economies of scale depend on the size of the company. New entrants may lack these, as the existing chains have developed large networks over time.

As I have argued above, low switching cost of consumers, has a strong influence on the threat of new entries, because consumers have little to no cost in choosing different products – and new entrants, that supply these products, are a threat to industry profitability.

Moderate threat to industry profitability
Therefore, the threat of new entries is viewed as moderate, because low switching cost and relatively low capital cost are a threat, but high cost of brand development as well as franchising makes it harder for new entrants.

Threat of substitutes

The price that customers are willing to pay depends, in turn, on the availability of substituting products (Grant, 2010: 10). A substitute is a product which fulfills the same need (Lecture, 6th July).

If there are few substitutes in an industry, it means that customers are insensitive to price, so the demand is inelastic in regards to changes in price. This is not the case in the fast food industry, however, as there are plenty of substitutes such as going out on a restaurant, buying ready meals at the supermarket or cooking at home. So if the price on hotdogs at a fast food joint increases, it will increase the demand for products are a store, which you can cook for yourself.

There is relatively low switching cost associated with making a meal at home, as the switching cost of cooking at home is the opportunity cost of spending time in the kitchen (Marketline, 2017). Even though fast food is fairly cheap, a cost-per-serving analysis has found that home cooking is in fact 24% cheaper than the already cheap McDonald's 1,07$ double cheeseburger, provided that it was bought in bulk (Hamm, 2007). But then again, convenience and availability are main drivers in choosing fast food companies, which limits the threat of this substitute.

Another important thing to consider in the fast food industry is the rising attention to public health. In 2010 the US Congress passed a health-reform bill, which requires larger fast food chains to state their calorie-content (Marketline, 2017). The main substitute would again be preparing a home cooked meal. Company response has come in more nutrition friendly green beans (KFC, 2017) or carrots instead of fries at McDonald's (McDonalds, 2017).

Moderate threat to industry profitability
Overall the threat of substitutes is viewed as moderate, because switching cost are low, but the convenience of fast food limits the threat of substitutes.

Rivalry

Overall, there are many different players making up the competitive landscape in the fast food industry, and this makes rivalry fierce amongst different companies. Some segments are very concentrated, for instance the burger segments with Burger King and McDonald's as key players (Marketline, 2017), but the industry as a whole is very fragmented. Both global chains and smaller independent operations are present (Industry Report, 2017). We can see this fragmentation in the number of firms and their relative number of employees: In 2016 the amount of fast food firms with 1-4 employees was 64,246, while the larger corporations with 500+ employees was 14 (see appendix 1).

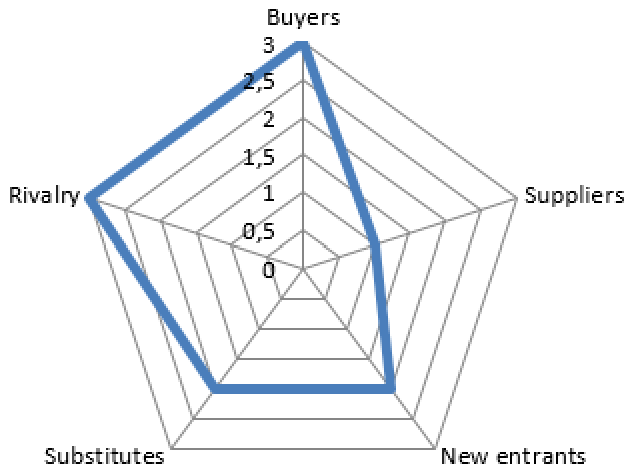
Additionally, the major player in the industry, McDonald's, sits on 22% of the market share, which does not indicate monopoly, and a variation of other, smaller players share the rest (Marketline, 2017).

There is a fairly high degree of firm aggressiveness in this industry (Gregory, 2017). This implies that the risk of retaliation is high, for instance through price wars, which can erode the margin of profit (Marketline, 2017). Therefore, branding becomes a vital source differentiation.

High threat to industry profits
Therefore, the degree of rivalry is a strong force in the fast food industry.

The attractiveness of the industry

Players in all sizes of the fast food industry a reliable on low margin-high turnover operations in order to get profit. The buyers large bargaining power combined with a moderate threat of new entrants suggests that internal resources and capabilities may be an important, and more secure, road to profit margins in the industry. Key established players, with large franchises and brand loyalty, such as McDonald's, split the largest profit margins (Marketline, 2017), which makes the industry less attractive to new entrants, although there a few capital requirements when starting up. I have summed up my industry analysis in this model:



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Appendix 1

SIZE OF FIRM INDUSTRY ESTIMATES

Year	Establishments by Size of Firm									
	1-4 Emps.	5-9 Emps.	10-19 Emps.	20-49 Emps.	50-99 Emps.	100-249 Emps.	250-499 Emps.	500+ Emps.	Unknown Emps.	Total
2016	63,273	35,631	54,665	65,814	11,874	808	37	14	8,888	241,003
2017	64,246	36,178	55,505	66,825	12,056	820	37	14	9,024	244,706
2018	65,396	36,826	56,498	68,022	12,272	835	38	15	9,186	249,087
	Sales ($Millions) by Size of Firm									Total
2016	6,034	8,931	34,456	109,801	43,546	7,986	1,217	1,108	96	213,175
2017	6,287	9,306	35,903	114,412	45,375	8,322	1,268	1,146	100	222,120
2018	6,552	9,697	37,412	119,223	47,283	8,672	1,322	1,183	105	231,449
	Employment by Size of Firm									Total
2016	158,183	206,659	743,441	1,981,000	705,309	101,885	10,630	11,553	8,888	3,927,548
2017	160,614	209,834	754,864	2,011,438	716,147	103,450	10,793	11,731	9,024	3,987,896
2018	163,489	213,591	768,379	2,047,451	728,969	105,303	10,986	11,941	9,186	4,059,295