

7 Five-forces Competitive Analysis

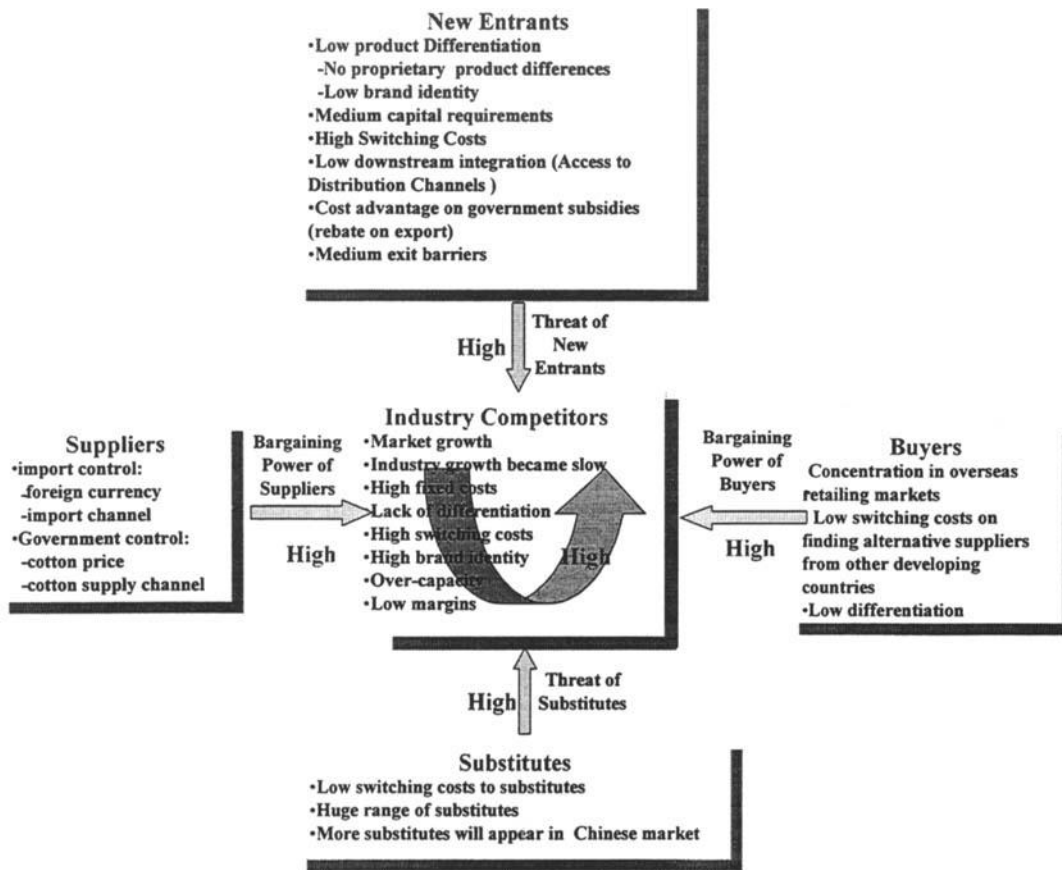
7.1 PORTER'S FIVE-FORCES MODEL

A useful way of gaining insight into the nature of competition is through industry analysis. As a working definition, an industry can be defined as a "group of firms that produce products that are close substitutes for each other."

In 1980, Porter defined the five forces that reflect the fact of competition in an industry [1]. He contended that the competitive environment is created by the interaction of five different forces acting on a business. The five competitive forces include entry, the threat of substitution, the bargaining power of buyers, the bargaining power of suppliers, and rivalry among current competitors. Porter's 'five forces' model provides a practical analytical tool for describing the forces that shape competitive strategy. It forms an important element of environmental analysis.

As Porter explained, the threat of entry into an industry depends on the barriers to entry, and the fact that the new entrant brings new capacity, the desire to gain a market share, and often substantial resources. Rivalry among existing industry members occurs because one or more competitors either feels the pressure or sees an opportunity to improve their position. All firms in an industry are competing with others producing substitute products, which limits the potential returns of an industry. The force from buyers is that they are forcing down prices, bargaining for higher quality or better services. The force from suppliers is that they exert bargaining power by threatening to raise prices or reduce the quality of purchased goods and services [1].

After diagnosing the forces affecting competition in an industry and their underlying causes, and identifying the strengths and weaknesses of the analyzed subject relative to the industry, possible approaches of competitive strategy, including offence or defense (positioning, influencing the balance, and exploiting chance), can be taken.



7.1 Five-forces analysis for China's denim industry

Relating the Chinese denim industry to its environment is the essence of the competitive strategy the industry relies on. Using Porter's 'Five forces' model, we have analyzed the key aspects of the Chinese denim industry's environment and competition, which are the essence of the related competitive strategy. The goal of this section is to find a position for China's denim industry in which the industry can best defend itself against these competitive forces or can influence them in its favor.

7.2 THREAT OF ENTRY

New entrants bring competitive forces such as new capacity, the desire to gain a market share, and often substantial resources. In the case of China's denim industry, a number of factors determined that the threat of entry was high. First is the low product differentiation; second is the low entry barriers, and the third is the medium exit barrier. We analyze the aspects that determine the entry barriers of the China denim industry in turn.

Low product differentiation

The product of the China denim industry is of low differentiation, which shows itself mainly in its low brand identification and mass product with low value added, low technology and lack of fashion design. A large proportion of the firms in the industry rely on processing business and their value chain is short. This causes low value

added products to be produced. Weaknesses in technological development, utilization and commercialization means that the industry makes few little products demanding the application of new material, high quality, and good design. At the same time, the products from the industry are also weak in brand identification. In the long term, China's producers have been satisfied with the status as a processor in the world's denim producing industries. Building brand awareness requires huge investment on advertising. For example, Levi's, an internationally famous brand, invested about US\$100 million per year to on advertising improve the brand awareness of customers. Chinese producers, limited by the shortage of cash, mostly have little power to build self-brands in the market. As an export-oriented industry, and an important denim producer, it has owned no world famous brand till now.

Low entry barrier

The sources of an entry barrier include economies of scale, product differentiation, capital requirements, switching costs, access to distribution channels, and government policy. Factors ensuring that the entry barriers of the China denim industry were low included:

1. Medium capital requirement. The denim industry is a labor intensive industry rather than capital intensive one. To invest in a denim-line needed about US\$ 5-7 million if machinery was to be imported from developed textile machinery producing countries, though less if domestically made. The capital requirement is not large compared with other industries.
2. Government subsidies. Since the denim industry is a labor densely industry, it provides large employee opportunities, which is very important to China because of huge pressure from the large number of unemployed. On the other hand, the denim industry is export-oriented, a foreign currency earner, and to encourage these exports, rebates on export were launched. Such government subsidies attracted small and medium size enterprises interested in the denim business.
3. Traditional distribution channels played an important role in the Chinese denim business. Traditional distribution channels, such as jobbers and wholesalers were still the two most important styles. Few of the denim producers have integrated downstream with distribution channels. They have little power to control outlets. Some distribution channels well known overseas, such as specialty stores, chain stores, warehouse stores, have, however, been introduced into recent years. A specialty store selling jeans appeared in China in 1995. Because most of the enterprises in the denim business were small or of medium size, they have little power to build self-distribution channels. Because of this, the distribution channels tend to be controlled by others.

The above factors combine to ensure that the entry barrier to the Chinese denim industry was low that the new comer could enter the industry with medium capital requirement, and little challenge from the distribution channels. At the beginning of the 1980s, investors were attracted by the high profit margins in the industry, and invested much in the denim business. The capacity of the China denim industry grew quickly in that period. However, a few years later, over-capacity reduced the margin and the investment return was poor, bringing huge pressures to the investors.

Medium exit barrier

Much machinery and equipment in denim manufacturing are specially designed to make denim, such as continuous pad dyeing with sizing machines. A switch to another business means that much of the machinery and equipment would be unusable.

The three aspects, low product differentiation, low entry barriers, and medium exit barriers, determined that the threat from new entrants to the China denim industry was high.

7.3 INTENSITY OF RIVALRY AMONG EXISTING COMPETITORS

When competitors either feel the pressure or see an opportunity to improve their position, rivalry occurs. The factors that result in intense rivalry include numerous or equally balanced competitors, slow industry growth, high fixed or storage costs, lack of differentiation or switching costs, capacity augmented in large increments, diverse competitors, high strategic stakes and high exit barriers [1].

After quickly growing in the 1980s and the beginning of the 1990s, the Chinese denim industry entered a period in which it developed developing slowly. Its total market size reduced, although its domestic market grew sharply. Its foreign market shrank much in recent years (as discussed in sections 3 and 4). The production reduced and over-capacity appeared from the second half of the 1990s, and the competition for market share became stiff.

As we discussed in the earlier section (threat of entry), the low capital requirement, high profit margin and government subsidies attracted many investors to the denim business in the 1980s and the first half of the 1990s, which caused quickly product capacity in the period. However, limited by lack of capital, most of the firms in denim manufacturing owned only one sizing-dyeing finishing line (just eight firms owned four lines), so that the production capacity is not concentrated in a few firms. Numerous similar denim manufacturers were competing in a battlefield. Because of weaknesses in marketing skills, simple and traditional tactics like price competition was always applied. As regards to marketing promotion, many manufacturers tended to promote their products via strengthening their relationship with clients.

Many firms faced high loan interest in past years because they had borrowed from the bank to buy machines and equipment. The interest rate was high in China in most years in the 1990s. This brought high pressures on the costs, and reliance on price oriented strategies, price wars booms between competitors further eroded the profit margin.

In recent years, existing over capacity and the market's recession have made the growth of the denim industry in China slow. High fixed costs, medium exit barriers, and lack of differentiation in products (discussed in our section on Threat of entry) ensured this. In order to expand, competition among existing firms was stiff.

7.4 PRESSURE FROM SUBSTITUTE PRODUCTS

All firms in the denim industry are competing with industry's producing substitute products, for example, non-denim casual wear, formal wear, and sports wear. In the

view of Porter, substitute products limit the potential returns of an industry by placing a ceiling on the prices firms in the industry can profitably charge [1].

Substitute for denim range from non-denim casual wear to new fiber material. Nowadays, few people are willing to sacrifice comfort for fashion, and care first and foremost about comfort. Casual attire has been accepted in different occasions, in the workplace or in entertainment. Denim's advantage is in its traditional, emotional image, and its disadvantages are the fact that its sensory properties run counter to modern consumer trends and requirements. Non-denim casual wear is the principal substitute for denim apparel. For example, the sale of slacks has increased greatly in recent years. The most important denim apparel, jeans, has faced a strong challenge from "Khakis Flat Front", which are becoming as important as jeans in a people's wardrobes. Today "khakis" or "chinos" are becoming a staple — alongside jeans — of casual dressing for both men and women in the US market, in the European market and in China, by and large. China is also an important non-denim casual wear producer with huge production capacity.

Denim is also challenged by synthetic-fiber and high-performance fabrics. Any fabric, with ease of care and comfort, whether 'denim look' or not, is a substitute for denim. The existing and potential substitutes for denim threaten the denim business and limit its profitability. After China becomes a WTO member and opens its market further; more foreign producers will enter the Chinese domestic market with their high tech products, new materials and fashion style jeans. They would provide denim products of high quality with famous brand names. More producers existing means that buyers could select the products widely; buyers can easily find substitutes from other foreign producers.

Summarizing above about the threat from substitutes, we conclude that the threat to the Chinese denim industry from the substitutes is high, no matter whether it is from vast substitute apparel, fabric made from new material, or denim apparel made by foreign producers that are well designed, of high quality, and with famous brand names.

7.5 BARGAINING POWER OF BUYERS

Buyers compete with the industry by forcing down prices, bargaining for higher quality or better service, and playing competitors against each other--all at the expense of industry profitability [1]. The bargaining power of buyers depends on buyer concentration, undifferentiated products, and low switching costs for buyers, etc.

In the case of China's denim industry, the bargaining power of buyers arises mainly from the industry's concentration on the overseas retailing marketing, which can easily find alternative suppliers from other developing countries and primarily, its undifferentiated products.

A big part of the Chinese denim production was exported to the US and EU markets. However, the EU and US clothing retail markets are concentrated. A few buyers can give large order and have high requirements on deliver times, quality and price. China's denim producers have little control over the distribution channels, and rely on jobbers to distribute goods to overseas markets. Consequently, retail markets concentration is factor in improving the bargaining power of buyers.

Meanwhile, the low differentiation of Chinese denim products means that buyers can find alternative suppliers easily because numerous competitors exist from developing countries, such as Thailand, Vietnam, India, and Pakistan, where the labor costs are similar to China, and which produce mass denim products. The industry mainly competes in price-sensitive market segments, and the strategy of the firms in the industry relies on price orientation that can easily be imitated by competitors. Buyers have increasing bargaining power over China's producers, always asking for better manufacturers' service, while reducing order sizes and delivery times.

7.6 BARGAINING POWER OF SUPPLIERS

Suppliers can influence the industry's margin by raising prices or reducing the quality of goods and services [1]. Suppliers can charge higher prices if they have a monopoly or offer a differentiated product.

The most important raw material to the China denim industry is cotton. Although China is the leading cotton producer in the world in recent years, the existing cotton supply policy meant that the Chinese denim industry had little flexibility to change suppliers. In China's domestic market, the strict monopoly on cotton purchases, marketing and storage led to the Chinese denim manufacturers having to face a single cotton supplier, a government specified company. Meanwhile, due to problems such as unstable cotton production, fast growth of downstream processing capacity, China's denim industry faced a scarcity of upstream raw material supplies. CCTV has reported that the cotton suppliers supplied low quality cotton to firms at high prices. The controlled cotton price and single cotton sale channel resulted in China's denim yarn industry facing great pressure from the bargaining power of the suppliers. On 13 January 1998, China's State Council decided to liberalize cotton prices from 1 September 1999 [2]. At that time, textile mills were allowed to buy their staple commodity directly from farmers. In that way, the bargaining power of suppliers to the China denim industry will be reduced.

In the cotton import market, a subsidiary company of the All China Federation of Supply and Marketing Cooperatives, named the China National Cotton Corporation was the most important company arranging the cotton import/export business. Except for this company, only a few large manufacturers could join the import cotton business. In addition, the import business was also arranged under foreign currency control.

The few cotton suppliers controlling the majority of the cotton supply have great bargaining power to the industry.

SUMMARY

Based on the above analysis, we have concluded that each of the five forces the China denim industry currently faces is high. There were high threats from new entrants and substitutes, high bargaining power from buyers and suppliers, and high intra-industry competitive rivalry.

This analysis has highlighted some weaknesses that really affect the industry's market advantage in competition. There were low differentiation products and lack of

marketing skill. These two weaknesses brought negative forces to the competitive ability of the industry, and are the critical two that the Chinese denim industry should improve and strengthen. The bargaining power of cotton suppliers will be reduced following the more open market economy policies launched by the government.

REFERENCES

1. Porter, M.E., *Competitive Strategy*.1980, New York, The Free Press.
2. China Economic Information Center., *Cotton sector to become market-wise next year*, . 1998, CEI . <http://www.cei.gov.cn/sicnet/siccew/efor.htm>