McKinsey SCP Framework

Idea In Short

The McKinsey SCP framework is a powerful tool for understanding and analyzing the competitive dynamics of an industry. It is based on the premise that there are three key factors that determine an industry's performance - structure, conduct, and performance.

Origin

The model, considered one of the pillars of the industrial organization theory, originated in 1933 with the publication by the economists Edward Chamberlin and Joan Robinson. In 1959, Joe S. Bain deepened the theory and described it in his book Industrial Organization. In the early 1980s, Michael Porter used the SCP paradigm as a basis for developing his competitive strategy, the five forces model. McKinsey updated the framework, adding dynamism by incorporating feedback loops between the steps. Additionally, it included an external market element known as external shocks.

SCP Framework

The SCP (Struct, Conduct and Performance) is a framework designed to analyze aspects related to structure, conduct and performance of the market. It helps establish a relationship between these aspects, thereby facilitating the identification of threats and opportunities. In a market economy, the model boasts a strong predictive capacity, accounting for up to 70% of the variability in profitability among industries based on their structural features. They occur outside the control of the industry, affecting the balance of the market, either on the supply side or the demand side. Some examples of external shocks are regulation, exchange rates, oil price, and natural disasters.

Structure

Structure refers to the characteristics of the industry, such as the number and size of firms,

the degree of product differentiation, and the barriers to entry and exit. The characteristics of the market structure rarely change.A market structure is defined by the characteristics of a market that shape the actions and outcomes of the business operating within it. It encompasses factors, such as:

- The industry's buyer structure
- The turnover of customers
- The extent of product differentiation
- The nature of costs of inputs
- The number of players in the market
- Vertical integration extent in the same industry
- The largest player's market share

Based on the aforementioned characteristics, identify four market structures:

1. Perfect competition
2. Monopolistic competition
3. Oligopoly, and
4. Monopoly

The structural characteristics of an industry have a significant impact on firm behavior and performance. Some of the key structural factors that influence industry dynamics include:

Number And Size Of Firms

The number and size of firms in an industry can influence the level of competition and the ability of firms to differentiate their products. For example, a highly concentrated industry with a few large firms may be more likely to see collusion and price fixing than an industry with many small firms.

Degree Of Product Differentiation

The degree to which products can be differentiated from each other can also influence competition and performance. For example, an industry with highly differentiated products may allow firms to charge higher prices and earn greater profits.

Barriers To Entry And Exit

The barriers to entry and exit in an industry can also affect competition and performance. For example, high barriers to entry may limit the number of new firms that enter the industry, which can lead to higher profits for existing firms.

Conduct

Conduct refers to the behavior of firms in the industry, such as pricing, advertising, and innovation. It refers to the strategies, policies, and behaviors that firms adopt to gain competitive advantages and influence pricing, production, promotion and distribution. Conduct changes occur more rapidly than in market structure. Some aspects related to the conduct are:

- Production capacity
- Mergers and Acquisitions (M&A)
- Innovation
- Research and Development (R&D) expenditures

The conduct of firms in an industry is influenced by the industry structure and the behavior of other firms in the industry. Some of the key types of firm conduct that can affect industry performance include:

Pricing

The pricing strategies of firms can have a significant impact on industry profits. For example, firms that collude on prices may be able to earn higher profits than firms that compete on price.

Advertising

The level of advertising in an industry can also affect competition and performance. For example, high levels of advertising can make it difficult for new firms to enter the industry and can lead to higher prices for consumers.

Innovation

The level of innovation in an industry can also affect competition and performance. For example, firms that are able to innovate and develop new products and services may be able to gain a competitive advantage and earn higher profits.

Performance

Performance refers to the overall profitability and efficiency of the industry. The result of the interaction between market structure and primarily, the firm's conduct encompasses aspects such as:

- Financial
- Growth
- Customer Service
- Brand
- Innovativeness
- Emerging technologies
- Novel management approaches

The firm's performance will first influence its conduct and subsequently that of its competitors. Ultimately, these effects will influence the market structure. The performance of an industry is measured by its overall profitability and efficiency. Some of the key metrics that can be used to assess industry performance include:

Profitability

The profitability of an industry is measured by the average profits earned by firms in the industry.

Efficiency

The efficiency of an industry is measured by how well the industry uses its resources to produce goods and services.

Causality

The SCP framework is a causal model, meaning that it proposes that structure influences

conduct, which in turn influences performance. However, the relationships between these three factors are complex and bidirectional. For example, firms' conduct can also influence the industry structure over time. The SCP framework can be used to understand a wide range of industry phenomena, such as:

- Why are some industries more profitable than others?
- How do industry changes affect firm behavior?
- What are the implications of government regulation for industry performance?
- How can firms develop competitive strategies that are successful in a given industry?

The Dynamic SCP Framework

In the 1980s, McKinsey suggested a dynamic version of the SCP framework that recognizes that the relationships between structure, conduct, and performance are not unidirectional. Instead, the dynamic view suggests that these three factors interact in a complex and dynamic feedback loop. For example, firms' conduct can influence the industry structure over time. This happens if firms in an industry collude on prices, this can make it more difficult for new firms to enter the industry, which can lead to a more concentrated industry structure. In turn, a more concentrated industry structure may make it easier for firms to collude on prices, and so on. The dynamic SCP framework is a more realistic and nuanced view of industry dynamics than the static framework. It allows companies to consider the influence of their own conduct on the industry structure and, ultimately, on their own performance.

Application

The SCP framework can be used to analyze the competitive dynamics of any industry. To do this, it is important to first identify the key structural characteristics of the industry, such as the number and size of firms, the degree of product differentiation, and the barriers to entry and exit. Once the industry structure has been identified, it is then possible to assess how the industry is performing and to identify any potential problems or opportunities. The SCP framework can also be used to develop competitive strategies. For example, firms can use the framework to identify ways to differentiate their products, to reduce costs, and to increase their market share. The framework can also be used to assess the potential impact of government regulation and other environmental factors on the industry.

Case Study - Airline Industry

The airline industry is a highly competitive industry with a number of large players. The industry is also characterized by high barriers to entry, such as the need to invest in expensive aircraft and the need to obtain government approval to operate. The SCP framework can be used to analyze the competitive dynamics of the airline industry.

Structure

The key structural characteristics of the industry include:

- Number And Size Of Firms
- Degree Of Product Differentiation
- Barriers To Entry And Exit

Number And Size Of Firms

The airline industry is dominated by a few large airlines, such as United Airlines, Delta Air Lines, and American Airlines. These airlines have a significant competitive advantage over smaller airlines due to their economies of scale and their ability to offer a wider range of routes and services.

Degree Of Product Differentiation

The airline industry is characterized by a high degree of product differentiation. Airlines differentiate themselves on the basis of factors such as price, quality of service, and flight schedules.

Barriers To Entry And Exit

The barriers to entry and exit in the airline industry are high. This is due to the need to invest in expensive aircraft and the need to obtain government approval to operate.

Conduct

The conduct of firms in the airline industry is influenced by the industry structure and the behavior of other firms in the industry. Some of the key types of firm conduct that can affect

industry performance include:

Pricing

Airlines compete on price to attract customers. However, airlines also need to be mindful of the costs of operating their businesses. Airlines often engage in price matching and other pricing strategies to compete with each other.

Advertising

Airlines advertise to promote their brands and to attract customers. Airlines also advertise to differentiate themselves from their competitors.

Innovation

Airlines invest in innovation to develop new products and services and to improve their efficiency. For example, airlines are investing in new technologies such as self-service check-in kiosks and mobile boarding passes.

Performance

The performance of the airline industry is measured by its overall profitability and efficiency. Some of the key metrics that can be used to assess industry performance include:

Profitability

The profitability of the airline industry is cyclical and is influenced by factors such as fuel prices and economic conditions. In recent years, the airline industry has been relatively profitable.

Efficiency

The airline industry is a relatively efficient industry. However, there is always room for improvement. For example, airlines are constantly looking for ways to reduce costs and improve their fuel efficiency. The SCP framework can be used by airlines to develop competitive strategies. For example, airlines can use the framework to identify ways to differentiate their products, to reduce costs, and to increase their market share. The

framework can also be used to assess the potential impact of government regulation and other environmental factors on the industry.

SCP In The Airline Industry

Here are some examples of how airlines are using the SCP framework to develop competitive strategies:

- Differentiation
- Cost Reduction
- Market Share Increase

Differentiation

Airlines are differentiating themselves on the basis of factors such as price, quality of service, and flight schedules. For example, some airlines are offering premium economy class seating, while others are offering more direct flights.

Cost Reduction

Airlines are reducing costs by improving their fuel efficiency and by automating tasks such as check-in and boarding.

Market Share Increase

Airlines are increasing their market share by offering new routes and services and by acquiring other airlines. Airlines can also use the SCP framework to assess the potential impact of government regulation and other environmental factors on the industry. For example, airlines can use the framework to assess the impact of new security regulations or of environmental regulations such as carbon emissions taxes.

Summary

The SCP framework is a powerful tool for understanding and analyzing the competitive

dynamics of an industry. It can be used by firms to develop competitive strategies and to assess the potential impact of government regulation and other environmental factors on the industry.