Potential Industry Earning (PIE)

Idea In Short

PIE is the value to the buyers of the goods and services produced less the value of the resources that are used to produce them. However, an industry can rarely capture all this value. Suppliers will capture some PIE by levying more than the opportunity cost of resources. Similarly, buyers who pay a price less than the maximum they are willing to pay will also typically capture some. Competition among the incumbent firms will dissipate some, and some will be lost to new entrants on the threat of entry.

In their 2001 textbook titled, Strategic Management, Garth Saloner, Andrea Shepard and Joel Podolny refined the Five Forces Model. They introduced the concept of Potential industry Earnings (PIE) to Porter's analysis to evaluate a firm's ability to capture its share of the industry profits. The addition - Potential Industry Earnings (PIE) - helps incumbent firms assess the share of profits that they could retain from the total value their industry generates.

PIE = Total value added by the industry – Total cost to produce the goods

Industries, such as solar electricity contribute high total customer value, but also entail an extremely high opportunity cost to produce goods. Photoelectric cells entail high Research and Development (R&D) costs as costs to produce, distribute and install the cells. Hence, a low PIE marks the photovoltaic industry. On the other hand, the diamond industry (e.g., De Beers) and the designer clothing industry (e.g., Zara) have high PIE. These industries leverage customers' emotions, behavioral nudges, purchasing patterns, and prevailing norms to create or increase the overall industry value. This is reflected in the high unit prices that customers are willing to pay to acquire them. Often, these products or services come at a low opportunity cost to their suppliers.

Potential entrants

Entry barriers, such as high capital costs, proprietary technology and patents, and scale and branding of existing competitors prevent profit erosion by new market entrants and competitors. Industries with low cost of entry and undifferentiated products such as ocean fisheries that only require a boat and a small crew, mean that existing players are unable to capture a large share of profits unless they can create some type of barrier to new entrants such as scale or branding or some sort.

Supplier power

Suppliers are providers of the inputs to the industry being evaluated. This may include labor unions and raw materials providers, among others. Concentration of suppliers and internal competition among them determine how much leverage suppliers can have over the industry and how much of the PIE they can capture.

Case - OPEC

In the petroleum industry, OPEC is the sole organization that has the power to manipulate the market. The concentration of suppliers and their power to cut off the supply gives it the ability to take PIE from the industry. This is how it ensures that the industry less attractive for new competitors.

Case - De Beers

The diamond wholesaling industry depends on diamond mining and purchasing cartels to provide its inputs. A few companies control a majority of diamonds sold on the market. De Beers, one of the largest players, has pushed towards a vertical structure. De Beers takes the diamonds to market itself, thereby cutting out the middle layers. The concentration of suppliers and its power to cut off supply gives the firm the ability to take PIE from the diamond wholesalers. As a result, the diamond mining industry is much less attractive to potential new competitors. Nevertheless, competition among suppliers also determines how much leverage each supplier has on the industry and the share of PIE they can capture.

Buyer power

Buyers are the outlets for the products of the industry. The power of the buyers can take away significant PIE from incumbents. The buyer power can erode significant PIE from incumbents. Their power is their ability to influence others' purchasing decisions. Concentration among buyers and their internal competitiveness are both determinants of buyer strength.

Case - Wal-Mart and Target

Wal-Mart and Target are very large customers of many consumer goods companies. They have a great deal of leverage over small and medium suppliers simply because of their size and scale. Not making it onto Wal-Mart's shelves can mean the difference between a successful and an unsuccessful product. With this knowledge, Wal-Mart buyers leverage their strength to lower wholesale prices. As a result, smaller manufacturers cannot capture a large portion of the PIE because there are substitutes for their products.

Substitutes

The availability of acceptable substitutes can cause buyers and end customers to bypass the industry products completely and lower the size of the overall PIE.

Case - STD

A few decades ago, people used Subscriber Trunk Dialing (STD) to make important calls. STDs served the time when cellular phones were so expensive that few users had access to them. Gradually, more substitutes entered the market and people started switching to mobile phones. Even today, many consider mobile phones a status symbol. Today, almost every user has his / her personal handset in their mobile phone. We also hardly see any STD booths. This is an example how acceptable substitutes shifted the PIE from Landline (STD) to the cellular phones.

Internal competition

Internal competition is usually less intense in industries where a few large players share a large portion of the market. These firms split PIE among somewhat differentiated products and services. However, these rules of thumb are not always true.

Case - Indian Real Estate

The boom in the real estate and construction industry in India saw a sudden and sharp increase in the price of cement up to the extent of 17% a month in 2007. The finding was not supporting that this happened because of demand-supply mismatch or increase in the cost of production. But because of few players trying to leverage in the hike of real estate industry, govt. took a disciplinary step and announced the import of cement. This impacted negatively on the PIE of the domestic player.

Case - OPEC

Similarly, OPEC, the cartel of oil rich countries, has recently been able to discipline the market and raise oil prices by limiting output. However, even it has been a victim of the free rider problem, with some countries secretly overselling their quota to maximize profits over the good of the whole.

Value disciplines

In 1992, the concept of value disciplines was introduced. This concept explains how some companies are able to achieve and maintain market leadership despite being in competitive industries. By identifying what is most important for an industry and its customers, you can make specific recommendations about the direction in which a company should go. Companies who surpass competitors in one of the three value disciplines can achieve success. The three value disciplines are:

1. Operational Excellence
2. Customer Intimacy, and
3. Product Leadership

Operational Excellence

Companies who employ this value discipline focus on efficient internal operations as the means to market leadership. For example, Toyota has used its manufacturing process leadership to produce high quality cars at a relatively low cost.

Customer Intimacy

Companies who pursue customer intimacy focus on understanding their customers' pain points and anticipating their needs. Amazon is a example of a company that creates a market segment of one for its customers by extensive recommendations and tailored marketing.

Product Leadership

Companies that exhibit product leadership are innovators, well ahead of the technology and product curves. For example, Nokia continuously pursues leading technology and product design to meet its customer needs.

Summary

By identifying what is most important for an industry and its customers, strategist can make specific recommendations about the directions in which a company should go. Operational excellence, Customer intimacy and product leadership these three value disciplines should be adopted to achieve and maintain market leadership despite being in competitive industries.