CHAPTER 2 LITERATURE REVIEW

2.1 SWOT Analysis

SWOT Analysis is to enumerate various major internal Strengths and Weaknesses, as well as external Opportunities and Threats that are closely related to the research subjects through surveys, arrange them in the matrix form, and then use systematic analysis to match various factors with each other and make analysis, from which a series of corresponding conclusions are drawn, and they usually to some extent are decision-making.

By using SWOT Analysis, a comprehensive, systematic and accurate study can be conducted on the situation of the research subjects, and based on the study results corresponding development strategies, plans and countermeasures can be formulated. SWOT Analysis, as one of the most commonly-used methods in strategic analysis, is often used to formulate group development strategies and analyze competitors.

SWOT Analysis to some extent is an internal analytical method of enterprises, that is to say, it analyzes according to the enterprise's internal conditions. SWOT Analysis has its foundation. The competitive theory put forward by the famous competitive strategy expert Michael Porter, starting from the industrial structure, thoroughly analyzes and explains the things an enterprise "possibly does", while the management specialists of the Capacity School use the value chain to deconstruct the value creation process of the enterprise, focusing on the analysis of the company's resources and capabilities.

Based on integration of the aforementioned two points, SWOT Analysis, represented by scholars of the Resource School, combines the internal analysis of the company (i.e. the research orientation of the authorities in the management community in the mid-1980s, represented by the Capacity School) and the external analysis of the industrial competitive environment (i.e. the central theme focused by the earlier strategic research, represented by Andrews and Michael Porter) so as to form its own structural and balanced systematical analytical mechanism. Compared with other analytical methods, SWOT Analysis has significant structural and systematic features from the very beginning. In terms of structuring, SWOT Analysis constructs a SWOT structural matrix in regard to the form and gives different analytical meanings to different regions of the matrix. In addition, regarding the content, the main theoretical basis of SWOT Analysis also emphasizes the analysis of the enterprise’s external environment and internal resources from the perspective of structural analysis.

The contribution of SWOT Analysis lies in the use of systematic thinking to combine these seemingly independent factors together. SWOT Analysis has four different types of combinations: Strengths-Opportunities (SO), Weaknesses-Opportunities (WO), Strengths-Threats (ST), and Weaknesses-Threats (WT).

The Strengths-Opportunities (SO) strategy is an ideal strategic model to develop internal strengths and make use of external opportunities. This strategy can be adopted when the enterprise has strengths in certain aspects and the external environment provides favorable opportunities for the strengths. For example, external conditions such as bright market prospects for products, expansion of suppliers, and financial crisis of competitors, together with internal strengths like the increase of the enterprise’s market share, can be favorable conditions for an enterprise to purchase competitors or expand production scale.

The Weaknesses-Opportunities (WO) strategy uses external opportunities to make up for internal weaknesses and enables an enterprise to turn weaknesses into strengths. If there are external opportunities but the enterprise is prevented from taking advantage of them due to internal weaknesses, it can take steps to overcome these weaknesses first. For example, if an enterprise’s weaknesses are inadequate supply of raw materials and insufficient production capacity, from the perspective of costs, the former will lead to deficient operation, idle production capacity, and rising unit costs, while overtime work will lead to additional costs. Under the premise of promising market prospects of products, the enterprise can take advantage of the opportunities such as suppliers’ expanding scale, price cuts of new technology and equipment, and competitors’ financial crisis so as to implement vertical integration strategies, restructure the enterprise’s value chain to ensure the supply of raw materials. In the meantime, purchasing production lines may be considered to overcome the weaknesses including lack of production capacity and equipment aging. By overcoming these weaknesses, enterprises may further use various external opportunities to reduce costs, obtain cost advantages, and ultimately gain competitive advantage.

Strengths-Threats (ST) strategy refers to the use of the enterprise’ own strengths to avoid or mitigate the impact of external threats. For example, if the competitors use new technology to reduce costs substantially, it will put a great cost pressure on the enterprise; at the same time, the supply of materials cannot be ensured, probably causing price increase; consumers demand a significant increase in product quality; the enterprise also has to bear high environmental costs; etc. All these will lead to further deterioration of the enterprise's cost situation, making it very disadvantageous in competition. However, if the enterprise has sufficient cash, skilled technicians and relatively strong product development capabilities, it can use these advantages to develop new techniques, simplify the production process, and improve raw material utilization, thereby reducing material consumption and production costs. In addition, the development of products with new technology is also an option for the enterprise. The development and application of new technologies, new materials, and new techniques are the most potential cost-reducing measures, while improving the quality of products and thus avoiding the impact of external threats.

The Weaknesses-Threats (WT) strategy is a defensive method designed to reduce internal weaknesses and avoid external threats. If an enterprise has internal and external problems, it often faces a crisis of survival, when lowering costs may become the main measure to change the weaknesses. When the situation of the enterprise's costs deteriorates with insufficient supply of raw materials, inadequate production capacity, unachievable scale benefits and the equipment aging, the enterprise may not be able to take measures on the costs. It will be forced to adopt a market focus strategy or a differentiation strategy to avoid weaknesses on costs and the threats thereby caused.

2.2 Theory of Industrial Competitiveness

The Theory of Absolute Advantage is also called the Theory of Absolute Cost, or the Theory of Territorial Division of Labor. This theory deduces the principle of division of labor among different occupations and different types of work within a country to the division of labor among countries, thus forming its theory of international division of labor. The Theory of Absolute Advantage is the earliest theory for free trade and was founded by Adam Smith, the chief representative of the British School of Classical Economics. The absolute cost refers to the absolute difference in the labor costs of producing a certain product between two countries, that is, the labor costs consumed by a country is absolutely lower than that of the other country.

The Theory of Comparative Cost, founded by David Ricardo, another famous representative of the British School of Classical Economics, inherits and develops of the Theory of Absolute Cost and further perfects the international trade theory of the

School of Classical Economics. The Theory of Comparative Cost holds that the foundation of international trade is not limited to the absolute differences in production technology. As long as there are relative differences in production technology among countries, there will be relative differences in production costs and product prices, which will enable countries to have comparative advantages in different products, make international division of labor and international trade possible, and then gain comparative interest. In short, the Theory of Comparative Advantage further analyzes and reveals the mutual benefit of international trade and the necessity of international division of labor. It proves that countries can realize the mutual benefit of trade by importing relatively low-cost products while importing relatively high-cost ones. The core of David Ricardo's Theory of Comparative Cost is the principle of comparative advantage and it reveals the philosophy of human's division of labor. For more than one hundred years since its foundation, the Theory of Comparative Cost has been regarded as a classic by Western economics community and become the main thread of the theoretical development of the division of labor in international trade. Even today, it is still a logical starting point for the study of international trade theory. The revelation of the Theory of Comparative Advantage is "All countries should implement a free trade policy to ensure the benefits of participating in the international division of labor and trade." However, this theory only proposes a basis for the international division of labor and fails to reveal the main reasons for the formation and development of the international division of labor, and the international meaning of the law of value.

As the inheritance and development of Ricardo's Theory of Comparative Cost, Heckscher and Ohlin put forward the Factor Endowment Theory, explaining the causes of international trade with the abundance and shortage of production factors. Ohlin believes that the absolute difference in commodity prices is due to the absolute difference in costs, which is the result of (a) the different supplies of production factors, i.e. the different factor endowments of the two countries; (b) different proportions of factors used in the manufacturing process of different products (different factor intensity). Despite the questioning by scholars such as Leontief, the Factor Endowment Theory has been regarded as a criterion in contemporary international economic theory since its establishment. The western economics community believes that this theory constitutes a major challenge to Ricardo's Theory of Comparative Advantage which belongs to the School of Classical Economics and has laid the foundation for contemporary international trade theory. The Heckscher–Ohlin Theorem helps analyze, judge and predict the trade patterns of all countries in the world, as well as formulate corresponding countermeasures so as to know ourselves and the competitors and to take the initiatives in the international competition full of risks. In addition, it ought to be recognized that a country's production factors are variables and their quantity, quality, and structure will change with the increase of productivity and the development of science, technology and education. The contemporary technological revolution has changed the connotation of the factors by promoting the integration of tangible and intangible factors such as human capital, technological innovation and information capital, so as to give new meanings to production factors. Therefore, we cannot treat the comparative advantages of factor endowments in a one-sided and static manner. This is the scientific attitude that we should take to the Heckscher–Ohlin Theorem.

2.3 Michael Porter's Five Forces Model

The Five Forces Model, proposed by Michael Porter in the early 1980s, has a global and profound impact on corporate strategy development. It is used for the analysis of competitive strategy and can effectively analyze customers' competitive environment. The five forces are the bargaining power of suppliers, the bargaining power of buyers, the threat of new entrants, the threat of substitutes, and industry rivalry. The different combinations of the five forces ultimately affect the changes in the industry's profit potential.

The Five Forces Model brings together a variety of factors in a simple model to analyze the basic competitive situation of an industry. It determines the five main sources of competition: the bargaining power of suppliers and customers, the threat of new entrants, the threat of substitutes, and industry rivalry. The formulation of a feasible strategy should first confirm and evaluate the size of these five forces. The characteristics and importance of different forces will vary depending on industries and companies.(Li,2018)

2.3.1The Main Contents of the Five Forces Model

Challenges of existing competitors in the industry

Industry generally refers to the type of economic activity divided by the production of similar products, having the same manufacturing process or providing similar labor services. It is undeniable that every enterprise wants to get the largest share of the market and the largest number of customers; thus, competition among industries and challenges from competitors are inevitable. For enterprises themselves, they are always facing challenges, because competition within the industry is intangible and rapid. Only if the enterprise could timely identify the competition and take corresponding measures, may they survive in the industry for a long time.

Threat of new entrants

When a certain industry appears to be profitable and have optimistic prospects, it will attract many outsiders. Enterprises are known to be aimed at profit, so a large number of external competitors will enter the industry to compete for resources and customers, dividing market share, which will undoubtedly exacerbate competition and confrontation in the industry and cause the industry to enter saturation prematurely. Compared with potential competitors, the economic scale, cost advantages, and in-position advantage are all strengths that the original enterprises in the industry have, which leads potential competitors to comprehensively consider whether to enter the industry. At the same time, the original enterprises will set up barriers to entry in order to secure their market share and customers, the purpose of which is to deter potential entrants from participating in their competition. In order to ensure their own vested interests, the original enterprises will exert steadfast resistance against potential entrants and bring them a severe attack. For potential entrants, whether they can timely grasp the information and technology of the industry is also a major obstacle conversion and the costs of customer conversion are also a big problem because both the market and customers can hardly accept excessive conversion costs, which will exclude potential entrants. In addition, government policies and legal restrictions will also impose certain restrains on potential entrants. Some special industries do not allow other enterprises to enter.

Threat of substitutes

Substitutes are products that can partially or completely replace one product in function. With the rapid economic development, the update cycle of information, science and technology, etc. is continuously being shortened and there are more and more substitutes. Threats from substitutes will drive enterprises in the same industry to accelerate the development and protection of core technologies, which intensifies the competition in the industry, but inspires more innovation. Therefore, the more cost-effective substitutes are, the lower the conversion costs of customers will be, and the greater the impact and pressure that substitutes will have on the industry.

The bargaining power of suppliers

The production by enterprises cannot be without the suppliers' resource provision. Simply put, there is a game between enterprises and suppliers – the higher the scarcity and the importance of the resources of suppliers are, the bigger the possibility of enterprises accepting high prices will be. Conversely, if many suppliers want to supply resources for the same enterprise, they can only lower prices or provide more extra services to increase the chance of cooperation with the enterprise. If the intensity of suppliers is high while that of enterprises in the same industry is low, then it is probable that the suppliers will dominate the price. Because enterprises are too discrete to unite against the suppliers, allowing a large part of the initiative lies in the suppliers.

The bargaining power of buyers

When the enterprise acts as a buyer, it wants to purchase items with high cost performance at a low price; and when the enterprise becomes a seller, it wants to sell the products to the market and customers at a high price. It can be seen that regardless of whether the enterprise is a supplier or a demander, its power to bargain is closely related to its profits. The degree of the enterprise's forward integration reflects the relationship between the enterprise and its customers. With high forward integration, the customers may purchase the products at a lower price; but if the buyers' concentration is high, they will be in a relatively strong position, which is beneficial for them to obtain products with a high cost performance.

The combination of these five competitive forces determines the ability of an enterprise in an industry to obtain an average investment yield exceeding capital costs. The combined power of these five forces varies from industry to industry and changes with the development of the industry, presented as the inconsistency of the internal profitability of all industries.

These five forces determine the profitability of an industry because they influence factors such as prices, costs, and investment income. For example, the bargaining power of the seller affects the cost of raw materials and other input costs; the intensity of competition affects the prices and competitive costs; the threat of new entrants limits prices and requires investments to defend against their invasions.

Enterprises can influence these five forces through their strategies. If enterprises can influence the competitive advantages of their industries through these five forces, then they can fundamentally improve or weaken the industrial attractiveness and thus change the competition rules of the industry.

Michael Porter's Five Forces Model is a micro-environmental analysis in the analysis of external environment and is mainly used to analyze the competition pattern of enterprises in the industry and the relationships between the industry and other industries.

The significance of Porter's competitive model is that there are three types of successful strategic ideas in the fight of the five competitive forces, which are known to all: the overall cost leadership strategy, the differentiation strategy, and the specialization strategy.