3. External Environment

* The external environment influences the firms one way or another.
* It is made up of many segments or sectors.
* The external environment can be distinguished into 2 aspects:

(1) the General Environment and

(2) the Task/Industry Environment

* The General Environment is made up of segments that indirectly affect the firms.
* The Task/Industry Environment is made up of segments that directly influence the

firms on the firms.

|  |  |  |
| --- | --- | --- |
| Segments in General Environment indirectly influence the firms are: | | Segments in the Task/Industry  directly influence the firms are: |
| 1. Political-legal | P | 1. Buyers |
| 2. Economic | E | 2. Suppliers |
| 3. Sociocultural | S | 3. Competitors |
| 4. Technological | T | 4. Government agencies & administrators |
| 5. Environmental | E | 5. Local communities |
| 6. Legal | L | 6. Activist groups |
| Any change in these segments (factors) will not necessarily influence a business organisation straight away i.e. the effect is not so immediate for a business to make an immediate response to the change. | | 7. Financial intermediates |
| All these are known as Stakeholders as they have one way or another some interest on the firms and can shape the competition in an industry. |

In recent years the external environment has become more turbulent, complex and global and the firms have difficulty in interpreting the changes that are taking place in the external environment.

Firms, therefore have problem in getting the proper information about the external environment. They are placed in a *state of uncertainty* and have difficulty in making the appropriate decisions.

**Key Drivers for Change**

Key drivers for change are those factors in the environment that are likely to influence

the success or failure of an organisation’s strategy. In each industry there are specific

key drivers for change. For example a clothing retailer may be primarily concerned with social changes driving customer tastes and behaviour.

For a computer manufacturer is likely to be concerned with technological changes.

To overcome this difficult situation, firms engage in a process called External Environment Analysis, which involves 4 activities:

1. Scanning the environment
2. Monitoring the environmental changes
3. Forecasting outcomes based on monitored changes and trends.
4. Assessing the changes and trends to determine the timing & importance

These activities are known as Building Scenarios. They enable an organisation to have a detailed and plausible view of how the business environment might develop in the future. They are built on PESTEL analyses and the key drivers for change but do not offer a single forecast of how the environment will change.

The scenario planning does not attempt to predict the unpredictable: it is confined to consider the plausible alternative futures. Sharing and debating alternative scenarios improves organisational learning by making managers more perceptive about the forces

in the business environment and what is really important.

From each scenario managers can build contingency plans and strategies. Then they can monitor the environment to see how it is actually unfolding and adjust strategies accordingly.

General Environment

The most important factors are:

* Sociocultural
* Economic
* Technological
* Political-legal

Firms cannot control these factors and at the same time they are difficult to predict with

great precision.

***Sociocultural forces:***

* Role of government in health care & child care.
* Legality of abortion.
* Level of foreign investment or ownership.
* Drug addiction.
* Aids and other health problems.
* Social costs of restructuring or layoffs.

Each of these represents a different set of values, ideals and other characteristics that can affect the operation of firms.

***Economic forces:***

* Economic growth
* Interest rates
* Credit availability
* Inflation rate
* Foreign exchange rate
* Foreign trade balances

All these factors influence performance and behaviour of firms.

***Technological forces:***

Technological change creates new products, services and in some cases, new industries e.g. internet, handheld computers, direct satellite systems and cellular telephones.

(Technology refers to human knowledge about products and services and the way they are made and delivered.)

***Political-Legal forces:***

Governments provide and enforce the rules by which firms operate. They can also encourage new businesses through the provisions of tax incentives and subsidies or restructure organisations or close them.

Firms need to learn about regulations, comply with them and fostering good relationships with regulatory agencies.

**The Industry/Task Environment (The Competitive Environment)**

**Areas of study in this lecture:**

1. Stakeholders in the industry environment
2. Driving Forces (Forces of Change)
3. Michael Porter’s Five Forces of Competitive Framework
4. Dynamics of the Industry Structure:

* Industry Life Cycle,
* The Notion of Hypercompetitive Cycles of Competition, and
* Comparative Five Forces Analysis

1. Strategic Groups
2. Key Success Factors (KSFs)
3. Critical Success Factors (CRFs)
4. Strategic Customers
5. Strategic Gap

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**1. Stakeholders in the Industry Environment**

This industry environment consists of stakeholders with whom the firms interact on a fairly regular basis such as the suppliers, buyers, competitors, new entrants, substitute producers, government, local communities, activist groups, unions and financial intermediates.

(An industry refers to a group of similar firms that produce similar product or service and they compete directly with each other to win orders or sales in the market place.)

The intensity of competition within the firm’s industry is determined by basic competitive forces such as:

1. Threat of new entrants
2. Rivalry among existing firms
3. Threat of substitute products or services Porter’s five forces
4. Bargaining power of buyers
5. Bargaining power of suppliers and
6. Relative power of other stakeholders such as government, local communities and activist groups, unions and financial intermediates.

The stronger each of these forces, the more difficult it is for companies to raise prices and earn greater profits. A weak force is considered as an opportunity because it may allow the company to earn higher profits. In the short run these forces may act as constraints on a company’s activities. However, in the long run the company may change the strength of one or more forces to its advantage.

The *objective of studying* the industrial environment is to identify opportunities and threats.

An *opportunity* will help the firm to achieve strategic competitiveness, while a *threat* will +

**2. Driving Forces (Forces of change)**

* Driving forces refer to the changing conditions in an industry.
* They create incentives or pressures for change.
* They have the biggest influence on what kinds of change to take place in the industry’s structure and competitive environment.

Analysis of driving forces or forces of change is done in 2 steps:

1. Identify the driving forces in terms of the rate of change of the elements and the number of them change at the same time.
2. Assess the impact they will have on the industry.

Examples of common driving forces:

* The increasing globalization of the industry.
* Product innovation
* Technological change
* Entry or exit of major firms
* Changes in cost and efficiency
* Changes in buyer’s preferences
* Changes in the long-term industry growth rate.
* Market innovation
* Growing buyer preference for differentiated products instead of a commodity product.
* Changing social concerns, attitude and lifestyle.
* The Internet and the new e-commerce opportunities and threats.
* Diffusion of technical know-how accesses more companies and countries.
* Regulatory influence and government policy changes.

**3. Michael Porter’s Five Forces of Competitive Framework**

Porter (1980, 1985) argues that the profitability of an industry is determined by its market structure. His influential Five Forces model allows a manager to build up a picture of what is happening within an industry and how this will impact on the conduct of firms and their performance.

**Porter’s Five Forces of Competition Framework**

**Suppliers**

Bargaining power of suppliers

**Industry**

**Competitors**

**Potential** Threat of Threat of **Substitutes**

**Entrants** new entrants substitutes

Rivalry among

existing firms

Bargaining power of buyers

**Buyers**

These five forces of competition include three sources of “horizontal’” competition:

competition from substitutes, competition from entrants and competition from

established rivals; and two sources of “vertical” competition: the bargaining power

of suppliers and buyers.

**(i) Competition from Substitutes**

The price customers are prepared to pay depends on the availability of substitute products. The absence of close substitutes for a product, as in gasoline or cigarettes, means that consumers are comparatively insensitive to price. The existence of close substitutes means the customers will switch to substitutes in response to price increases for the product.

The extent to which substitutes limit prices and profits depends on the propensity of buyers to substitute between alternatives. It will depend on the price performance characteristics and the performance differences.

**(ii) Threat of Entry**

If an industry earns a return on capital in excess of its cost of capital, that industry acts as a magnet to firms outside the industry. Unless the new entry of firms is barred, the rate of profit will fall toward its competitive level.

The principal sources of barriers to entry are:

* High capital requirements
* Economies of scale
* Cost advantages
* Product differentiation enables existing to “lock in” their customers to their products.
* Brand identity of products or services of existing firms has been well accepted by buyers and it will cost the new entrants substantially to provide resources over a long period of time to get the new entrants’ brand identity accepted.
* Switching costs may be too high for new entrants to persuade existing customers to switch from current providers.
* Access to channels of distribution may become unavailable to intending new entrants.
* Governmental and legal barriers
* Retaliation by firms in the industry may prevent new entrants from coming in.

**(iii) Rivalry between established competitors**

Firms within the same industry compete with each other; some aggressively to the point of bringing the price below the cost of production. In this situation the industry wide losses are incurred. In others they do not compete on price but on other issues such as advertising, innovation and other nonprice dimensions.

Six factors play an important role in determining the nature and intensity of competition between established firms:

* Concentration – number of firms in relation to market share based on concentration ratio (CR).
* Diversity of competitors
* Product differentiation
* Excess capacity
* Exit barriers
* Cost conditions

**(iv) Bargaining Power of Buyers**

Buyers of an industry’s products or services can sometimes exert considerable pressure on existing firms to secure lower prices or better service. This leverage (bargaining power) is particularly evidence when:

1. Buyers are knowledgeable.
2. Buyers spend a lot of money on the industry’s products.
3. Buyers perceived the industry’s product as not critical to their needs and they are not concentrated than firms supplying the products.
4. Buyers noted the industry’s product not differentiated or has few switching cost and can enter the supplying industry fairly easily themselves (backward integration).

(**v) Bargaining Power of Suppliers**

Analysis of the determinants of relative power between the producers in an industry and their supplies is precisely analogous to analysis of the relationship between producers and their buyers. Suppliers can command bargaining power over an industry when:

* Their products are crucial to a buyer.
* They can erect high switching costs.
* They are more concentrated than buyers.
* They can potentially enter the industry.

***Implications of five forces analysis***

1. Provide useful insights into the forces at work in an industry or sector environment of an organisation.
2. Get an idea of the attractiveness of the industry or otherwise.
3. Allow a judgment to be made whether the industry is worth going in or competing with or getting out
4. What influence can be exercised to gain competitive edge

5. How competitors are competing in the industry

***Caution in using the five forces of competition framework***

1. Defining the right industry or segment of the industry as the competitive forces is likely to be different in different segments.
2. Converging industries then beware not to analyze the forces differently.
3. Complementary products – customers are prepared to pay more for complementary products that are worth more together than separately.

The structural determinants of the Five Forces of Competition

**Supplier Power**

Factors determining power of suppliers

relative to producers; same as those

determining power of producers relative

to buyers – see “Buyer Power” box.

**Threat of Entry Industry Rivalry Threat of Substitutes**

\* Economies of scale \* Concentration \* Buyer propensity

\* Absolute cost \* Diversity of competitors to substitute

advantages \* Product differentiation \* Relative prices

\* Capital requirement \* Excess capacity and and performance

\* Product differentiation exit barriers of substitutes

\* Access to distribution \* Cost conditions

\* Government and legal

barriers

\* Retaliation by **Buyer Power**

Price Sensitivity Bargaining Power

\* Cost of product \* Size and concentration

relative to total cost of buyers relative to producers

\* product differentiation \* Buyers’ switching costs

\* Competition between \* Buyers’ information

buyers \* Buyers’ ability to backward

integrate

**4. The dynamics of Industry Structure**

The industry structure does not remain static. It changes overtime in three possible situations:

1. The industry life-cycle
2. The notion of hypercompetitive cycles of competition
3. Comparative five forces analysis

**(1) Industry Life Cycle**

Development Growth Shake-out Maturity Decline

Market

size

Low rivalry: Low rivalry: Increasing Stronger Extreme

High Differen- High growth rivalry: buyers: rivalry:

Typical tiation & weak buyers Slower growth Low growth Many exits

Five Forces Innovation but low entry & some exits & standard & price

key barriers Managerial products, but competition

Growth & financial higher entry Cost &

ability key strength key barriers market commitment

share key key

***(2) Hyper competition and competitive cycles***

Competitors compete with each other in terms of price and innovations. When the

interactions i.e. cycles of competition become more often and intense, the stage of hyper competitiveness occurred. Such a situation leads to disrupting the status quo of the competition and no one is able to sustain long-term advantage. Competitive advantages of firms can only be temporary and is attained in terms of short-term moves.

***(3) Comparative industry structure analysis***

Rivalry

Low

Time 0

Substitute threat

Low

Entry threat High High

High

Low High High

Time +5

Low Low

Buyer power Supplier power

The above diagram provides a mean to analyze the industry structure by using the five forces. This is done by comparing the five forces over time in a simple ‘radar plot’. The framework shows the power of each of the five forces on five axes. Power diminishes as the axes go outward.

Where the forces are low, the total area enclosed by the lines is large; where the forces

are high the total area enclosed by the lines is small.

The larger the enclosed area is, the greater is the profit potential. At Time 0 the industry represented by the broken lines, has relatively low rivalry (few competitors) and faces low substitution threats. The threat of entry is moderate but both buyer power and supplier power are relatively high. This looks like a moderately attractive industry to invest in.

As the industry becomes more dynamic, managers have to look forward for the next 5 years as represented by the dark lines.

This time the threat of substitutes becomes great (new technologies available). The entry threat is expected to fall. The buyer power and supplier power are expected to ease. Rivalry will reduce still further. This is a situation where a few players have emerged and are dominating the industry.

The area enclosed by the dark lines is large, suggesting an attractive industry to invest in.

*Benefits of comparative industry structure analysis*

1. Comparing the five forces over time on a radar plot helps to give industry structure

analysis a dynamic aspect. Similar plots can be made to aid diversification decisions.,

where possible new industries to enter can be compared in terms of attractiveness.

2. If one of the forces is very adverse (powerful) this might nullify positive assessments on

the other four axes: e.g. an industry with low rivalry, low substitution, low entry barriers

and low supplier power might still be unattractive if powerful buyers were able to demand

highly discounted prices.

**5. Strategic Groups**

Strategic Group Mapping within Industries

The World Automobile Industry: Strategic Groups

High Ferrari

Lamborghini

Porsche

Mercedes

BMW

Toyota

Ford

Price General Motors

Chrysler

Honda

Nisson

Hyundai

Kia

Low

Low Breadth of Product Line High

* Firms within the industry can be distinguished into different strategic groups according

to certain criteria such as product line, technology used, type of buyer served, product

quality, distribution channels used and number of markets served.

* By aggregating firms into strategic groups, it makes the analysis of firms much easier.
* It helps managers to understand and compare their own firm’s strategic position

and actions with their rivals.

* Firms in the same strategic group have similar strategies, resources, markets, products and services, suppliers and competitors.

Managers can then create a strategic group map to understand the strategies of competitors, mobility barriers, strength of competitive rivalry and areas in the industry in which no firms are presently competing.

***Importance of strategic groups:***

Strategic group represents a valuable link between studying the behaviour of an entire industry and the behaviour of individual firms that comprise the industry. It is time consuming and labourous work to study the characteristics of every firm in the industry. If the firms in the industry can be classified into strategic groups, it would make the analysis of firms much easier. In this way, strategic group analysis becomes a useful tool to help managers understand and compare their own firm’s strategic position and actions with their rivals.

* Strategic group maps can help a firm to understand the strategies of competitors.
* They may also highlight an area in the industry in which no firms are presently competing.
* Another helpful use is in tracking the evolution of industry overtime. If movement from one group to another is difficult then it is likely that mobility barriers exist. Mobility barriers are similar to entry barriers but exist between strategic groups within the same industry.
* Furthermore, the closer strategic groups are to each other on the map, the stronger competitive rivalry among member firms tends to be. Firms in strategic groups that are far apart on the map hardly compete at all.

***Usefulness of Strategic groups concept as an analytical tool:***

1. Helps a firm to identify barriers to mobility that protects a group from attacks by other groups. E.g. technology, brand image, established network of servicing dealers.
2. Help a firm to identify groups whose competitive position may be marginal or tenuous. One may anticipate that these competitors may exit the industry or try to move into another group.
3. Helps chart the future directions of firms’ strategies.
4. Helpful in thinking through the implications of each industry trend for the strategic group as a whole.

(From Dess & Lumpkin, 2003, pp. 61-62)

**6. Key Success Factors (KSFs)**

* These are ***things in an industry*** that affect the success or failure of firms in terms of

profits or losses.

* They are prerequisites for industry success.
* They include product attributes, market achievements, competencies and competitive capabilities.
* They all have direct bearing on company’s profits.

For example

In the beer industry, the KSFs are:

* Full utilization of brewing capacity.
* A strong network of wholesale distributors.
* Clever advertisement.

Knowing the KSFs in the industry enables firms to know what kinds of resources are needed to be competitively valuable in order to attain sustained competitive advantage.

***Eight Factors to consider whether there is relative attractiveness or unattractiveness of the industry:***

1. The industry’s growth potential.
2. Strong or weak competitive forces.
3. Driving forces enable favourable or unfavourable profits to be made.
4. The company has the ability to take advantage of the weaknesses of weaker rivals.
5. The ability to defend against the factors that make the industry unattractive.
6. The degree of risk and uncertainty in the industry’s future.
7. The severity of problems confronting the industry as a whole.
8. Whether participating in the industry can help the firm to succeed in other industries in which it may have business interests.

If the overall profit prospects are above average, the industry can be considered attractive.

**7. Critical Success Factors (CSF)**

These are the ***product features*** that are particularly valued by a group of customers and therefore, where the organisation must excel to outperform competitors.

Different competitors for the same product may give different emphasis to factors valued by

customers such as reputation, after sales service, delivery reliability, testing and technical quality.

By comparing the CSFs of each competitor, it is possible to see value through the eyes of the customers and to be relative strengths.

**8. What are strategic customers?**

It refers to the person(s) at whom the strategy is primarily addressed because they have the most influence over which goods or services are purchased.

E.g. They are the loyal customers who have been buying the firm’s goods or services.

They are taken into consideration when preparing the strategy of the firm.

**9. What is a strategic gap?**

It is the opportunity in the competitive environment that is not being fully exploited by competitors.

E.g. in Porter’s five forces, strategic gap is where rivalry is low. In strategic group mapping, strategic gap is the unoccupied space between the strategic groups. Even customers can become the strategic gap for they provide the opportunity to produce the product or services they are looking for. Others strategic gaps are the complementary products and services or new market segments.

**Assignment**

Read the case study “Global forces and the European Brewing industry” on pages 88-91

of Johnson, Scholes and Whittington (2008) and answer the following questions:

1. Using the data in tables 1 and 2 in the case analyze the trends taking place in the consumption of beer.
2. Carry out a PESTEL analysis of the European brewing industry.
3. How do companies react to these changing trends in the brewing industry?

4. Use Porters five forces model to analyze the European brewing industry at case date?

5. At what stage of industry lifecycle is the brewing industry in Europe? Give reasons

for your answer.