CHAPTER 3

EVALUATING A COMPANY'S EXTERNAL ENVIRONMENT

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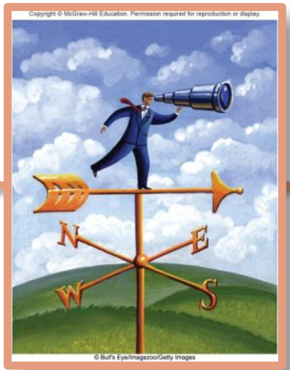
Learning Objectives



THIS CHAPTER WILL HELP YOU UNDERSTAND:

LO 1 How to recognize the factors in a company's broad macro-environment that may have strategic significance.

LO 2 How to use analytic tools to diagnose the competitive conditions in a company's industry.

LO 3 How to map the market positions of key groups of industry rivals.

LO 4 How to use multiple frameworks to determine whether an industry's outlook presents a company with sufficiently attractive opportunities for growth and profitability.

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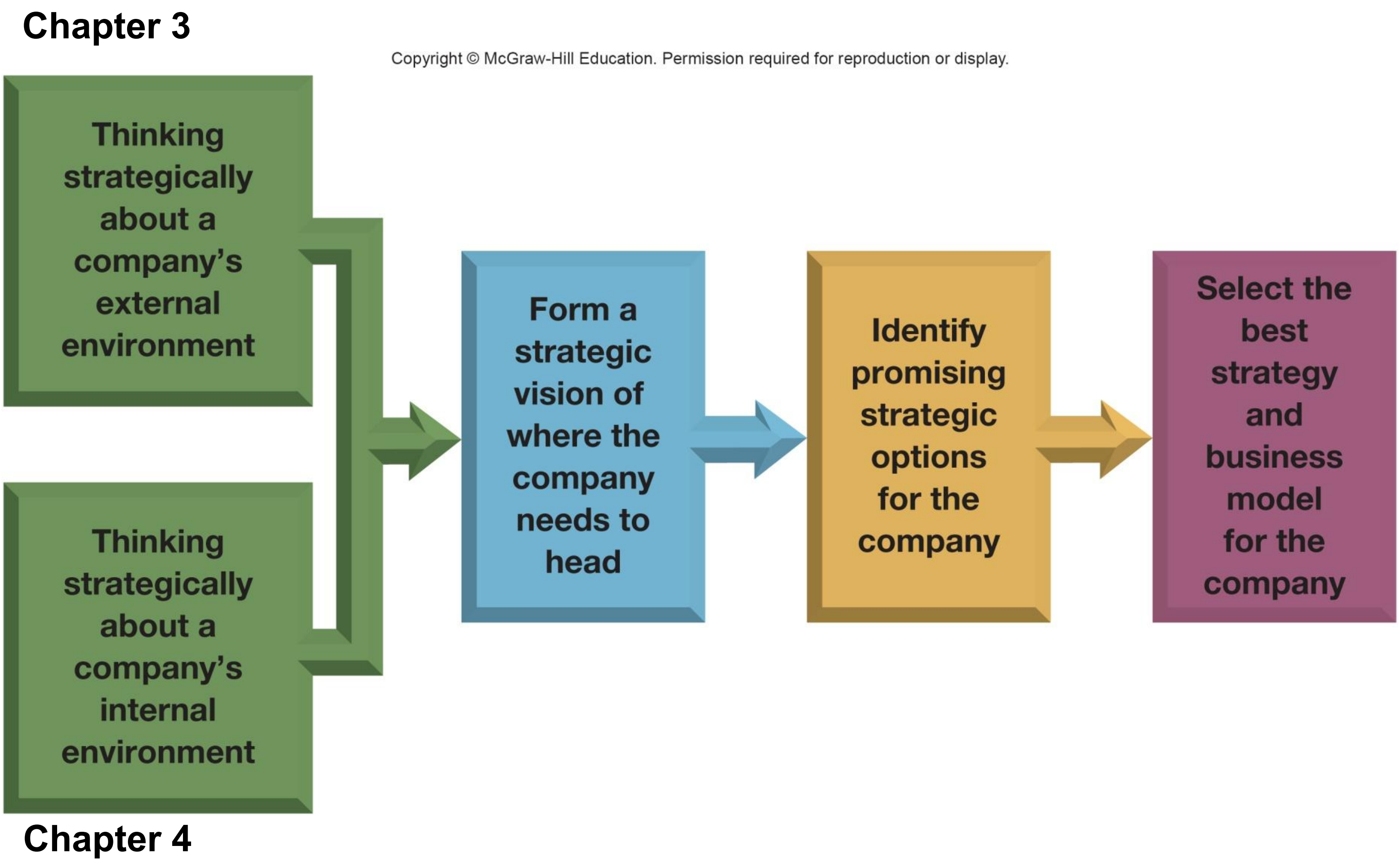
FIGURE 3.1 From Thinking Strategically about the Company's Situation to Choosing a Strategy



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CORE CONCEPT

- The **macro-environment** encompasses the broad environmental context in which a company's industry is situated that includes strategically relevant components over which the firm has no direct control.

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CORE CONCEPT

- PESTEL analysis focuses on the six principal components of strategic significance in the macro-environment:
  - **P**olitical
  - **E**conomic
  - **S**ocial
  - **T**echnological
  - **E**nvironmental
  - **L**egal

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THE STRATEGICALLY RELEVANT FACTORS IN THE COMPANY'S MACRO-ENVIRONMENT

- PESTEL Analysis
  - Focuses on principal components of strategic significance in the macro-environment:
    - **P**olitical factors
    - **E**conomic conditions (local to worldwide)
    - **S**ociocultural forces
    - **T**echnological factors
    - **E**nvironmental factors (the natural environment)
    - **L**egal/regulatory conditions

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FIGURE 3.2 The Components of a Company's Macro-Environment

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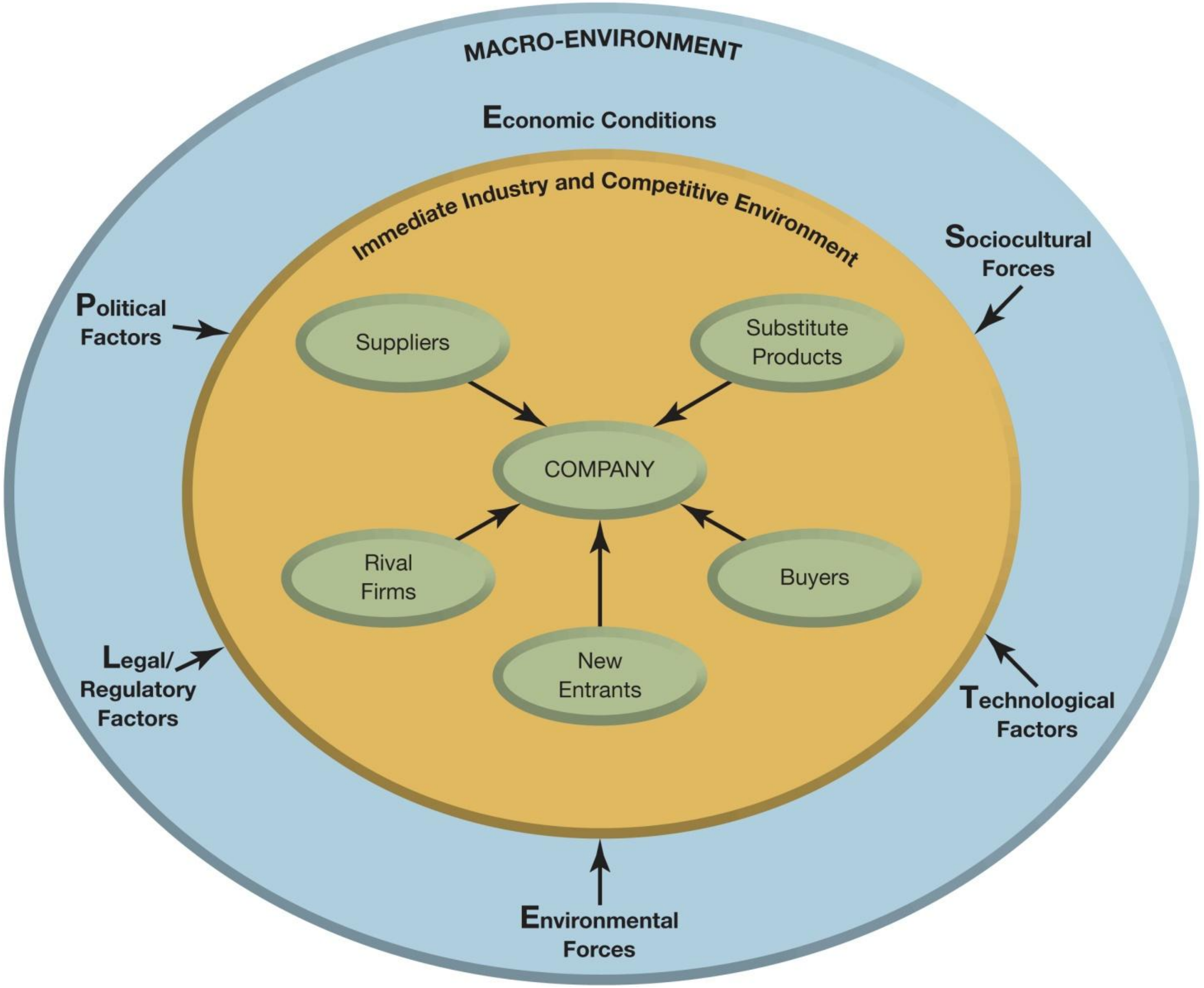

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TABLE 3.1 The Six Components of the Macro-Environment

Component	Description
Political factors	These factors include political policies, including the extent to which a government intervenes in the economy. They include such matters as tax policy, fiscal policy, tariffs, the political climate, and the strength of institutions such as the federal banking system. Some political policies affect certain types of industries more than others. An example is energy policy, which affects energy producers and heavy users of energy more than other types of businesses.
Economic conditions	Economic conditions include the general economic climate and specific factors such as interest rates, exchange rates, the inflation rate, the unemployment rate, the rate of economic growth, trade deficits or surpluses, savings rates, and per-capita domestic product. Economic factors also include conditions in the markets for stocks and bonds, which can affect consumer confidence and discretionary income. Some industries, such as construction, are particularly vulnerable to economic downturns but are positively affected by factors such as low interest rates. Others, such as discount retailing, may benefit when general economic conditions weaken, as consumers become more price-conscious.
Sociocultural forces	Sociocultural forces include the societal values, attitudes, cultural influences, and lifestyles that impact demand for particular goods and services, as well as demographic factors such as the population size, growth rate, and age distribution. Sociocultural forces vary by locale and change over time. An example is the trend toward healthier lifestyles, which can shift spending toward exercise equipment and health clubs and away from alcohol and snack foods. Population demographics can have large implications for industries such as health care, where costs and service needs vary with demographic factors such as age and income distribution.

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TABLE 3.1 The Six Components of the Macro-Environment

Component	Description
Technological factors	Technological factors include the pace of technological change and technical developments that have the potential for wide-ranging effects on society, such as genetic engineering and nanotechnology. They include institutions involved in creating new knowledge and controlling the use of technology, such as R&D consortia, university-sponsored technology incubators, patent and copyright laws, and government control over the Internet. Technological change can encourage the birth of new industries, such as the delivery drone industry, and disrupt others, such as the recording industry.
Environmental forces	These include ecological and environmental forces such as weather, climate, climate change, and associated factors like water shortages. These factors can directly impact industries such as insurance, farming, energy production, and tourism. They may have an indirect but substantial effect on other industries such as transportation and utilities.
Legal and regulatory factors	These factors include the regulations and laws with which companies must comply, such as consumer laws, labor laws, antitrust laws, and occupational health and safety regulation. Some factors, such as banking deregulation, are industry-specific. Others, such as minimum wage legislation, affect certain types of industries (low-wage, labor-intensive industries) more than others.

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ASSESSING A COMPANY'S INDUSTRY AND COMPETITIVE ENVIRONMENT

1. **How strong are the industry's competitive forces?**
2. **What are the driving forces in the industry, and what impact will they have on competitive intensity and industry profitability?**
3. **What market positions do industry rivals occupy—who is strongly positioned and who is not?**
4. **What strategic moves are rivals likely to make next?**
5. **What are the industry's key success factors?**
6. **Is the industry outlook conducive to good profitability?**

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THE FIVE FORCES FRAMEWORK

- The Five Competitive Forces:
  - Competition from rival sellers
  - Competition from potential new entrants
  - Competition from producers of substitute products
  - Supplier bargaining power
  - Customer bargaining power

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FIGURE 3.3

The Five-Forces Model of Competition: A Key Analytical Tool

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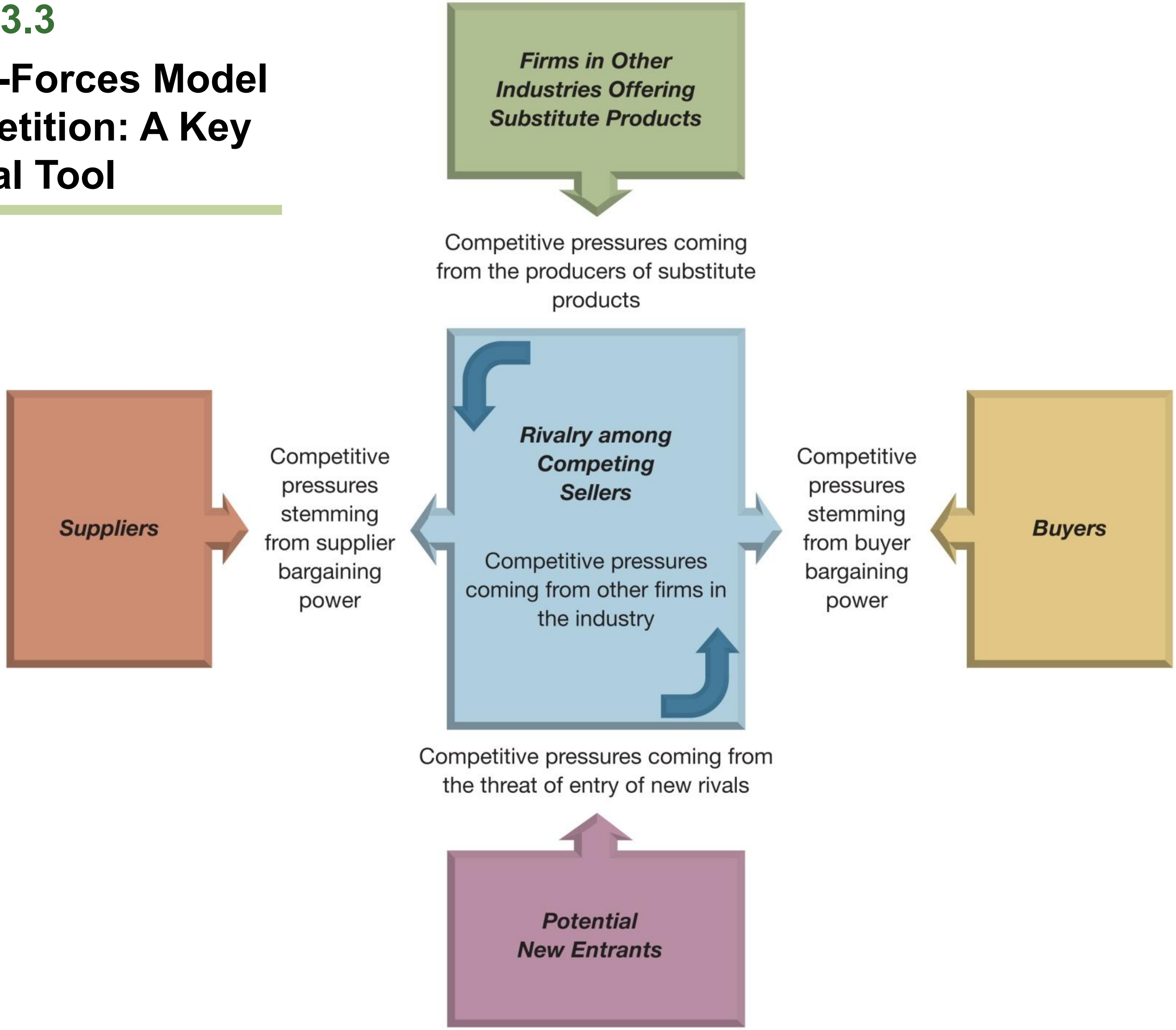

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USING THE FIVE-FORCES MODEL OF COMPETITION

Step 1	For each of the five forces, identify the different parties involved, along with the specific factors that bring about competitive pressures.
Step 2	Evaluate how strong the pressures stemming from each of the five forces are (strong, moderate, or weak).
Step 3	Determine whether the five forces, overall, are supportive of high industry profitability.

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COMPETITIVE PRESSURES THAT INCREASE RIVALRY AMONG COMPETING SELLERS

- Buyer demand is growing slowly or declining.
- It is becoming less costly for buyers to switch brands.
- Industry products are becoming less differentiated.
- There is unused production capacity, and\or products have high fixed costs or high storage costs.
- The number of competitors is increasing and\or they are becoming more equal in size and competitive strength.
- The diversity of competitors is increasing.
- High exit barriers keep firms from exiting the industry.

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FIGURE 3.4

Factors Affecting the Strength of Rivalry

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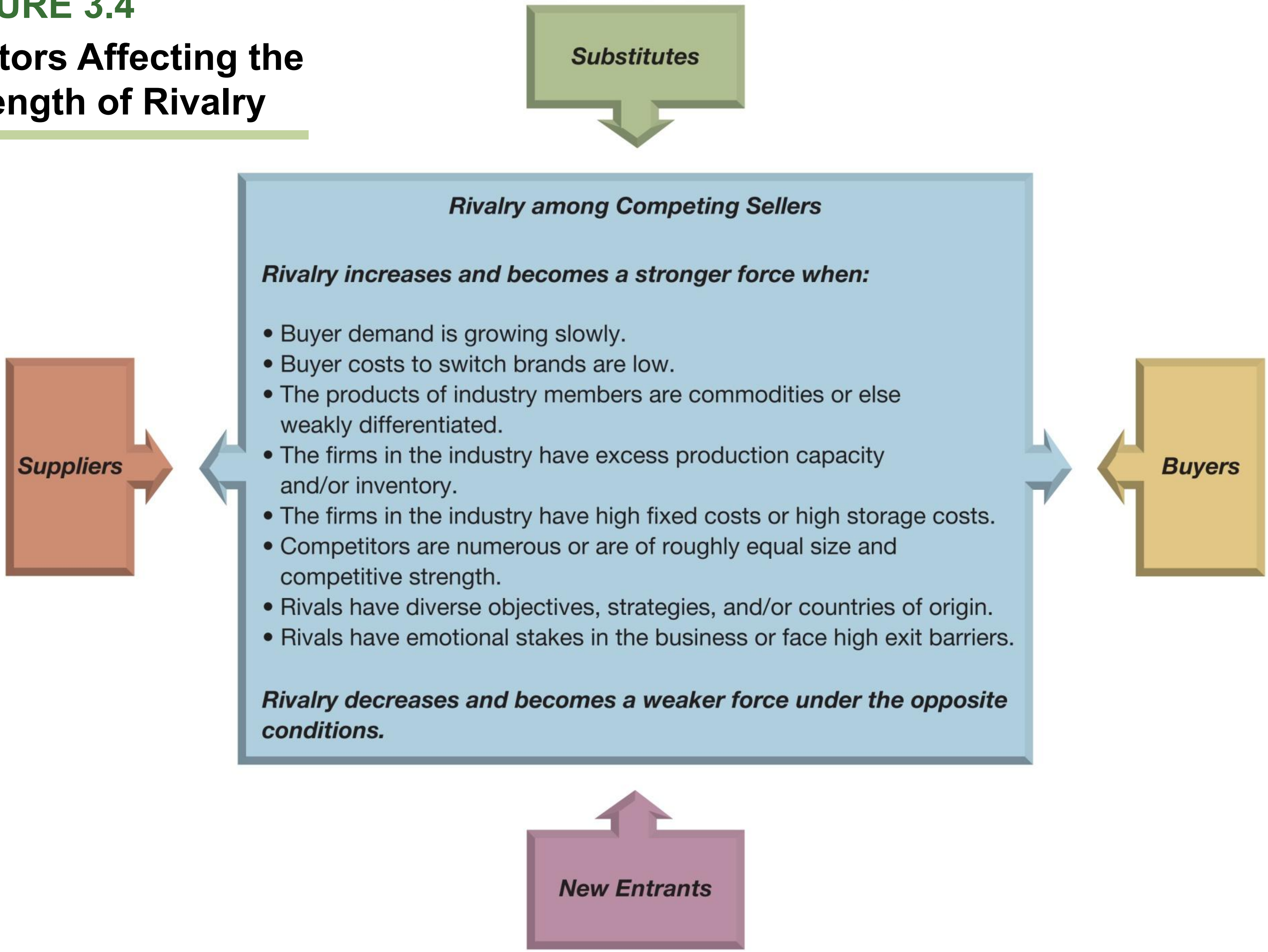

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TABLE 3.2 Common "Weapons" for Competing with Rivals

Types of Competitive Weapons	Primary Effects
Discounting prices, holding clearance sales	Lowers price (*P*), increases total sales volume and market share, lowers profits if price cuts are not offset by large increases in sales volume
Offering coupons, advertising items on sale	Increases sales volume and total revenues, lowers price (*P*), increases unit costs (*C*), may lower profit margins per unit sold (*P* – *C*)
Advertising product or service characteristics, using ads to enhance a company's image	Boosts buyer demand, increases product differentiation and perceived value (*V*), increases total sales volume and market share, but may increase unit costs (*C*) and lower profit margins per unit sold
Innovating to improve product performance and quality	Increases product differentiation and value (*V*), boosts buyer demand, boosts total sales volume, likely to increase unit costs (*C*)
Introducing new or improved features, increasing the number of styles to provide greater product selection	Increases product differentiation and value (*V*), strengthens buyer demand, boosts total sales volume and market share, likely to increase unit costs (*C*)
Increasing customization of product or service	Increases product differentiation and value (*V*), increases buyer switching costs, boosts total sales volume, often increases unit costs (*C*)
Building a bigger, better dealer network	Broadens access to buyers, boosts total sales volume and market share, may increase unit costs (*C*)
Improving warranties, offering low-interest financing	Increases product differentiation and value (*V*), increases unit costs (*C*), increases buyer switching costs, boosts total sales volume and market share

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COMPETITIVE PRESSURES ASSOCIATED WITH THE THREAT OF NEW ENTRANTS

- **Entry Threat Considerations:**
  - Expected defensive reactions of incumbent firms
  - Strength of barriers to entry
  - Attractiveness of a particular market's growth in demand and profit potential
  - Capabilities and resources of potential entrants
  - Entry of existing competitors into market segments in which they have no current presence

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MARKET ENTRY BARRIERS FACING NEW ENTRANTS

- Incumbent cost advantages related to learning and experience, proprietary patents and technology, favorable locations, and lower fixed costs
- Strong brand preferences and customer loyalty
- Strong “network effects” in customer demand
- High capital requirements
- Building a network of distributors or dealers and securing adequate space on retailers’ shelves
- Restrictive regulatory and trade policies

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STRATEGIC MANAGEMENT PRINCIPLE

- Whether an industry's entry barriers ought to be considered high or low depends on the resources and capabilities possessed by the pool of potential entrants.
- High entry barriers and weak entry threats today do not always translate into high entry barriers and weak entry threats tomorrow.

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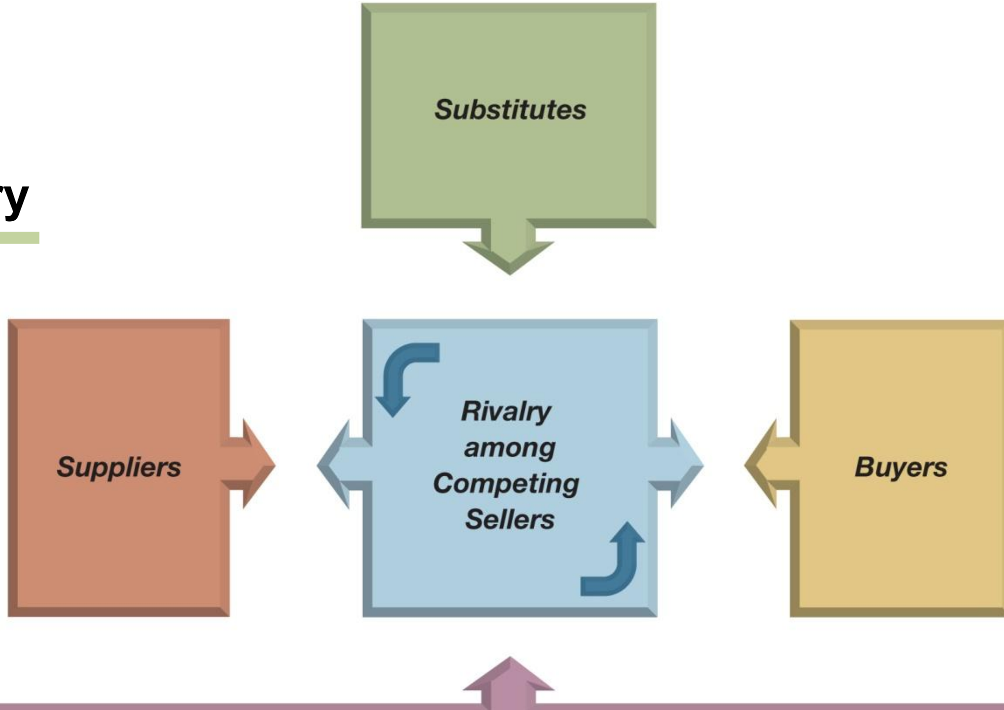
FIGURE 3.5

Factors Affecting the Threat of Entry



Competitive Pressures from Potential Entrants

Threat of entry is a stronger force when incumbents are unlikely to make retaliatory moves against new entrants and entry barriers are low. Entry barriers are high (and threat of entry is low) when:

- Incumbents have large cost advantages over potential entrants due to:
  - High economies of scale
  - Significant experience-based cost advantages or learning curve effects
  - Other cost advantages (e.g., favorable access to inputs, technology, location, or low fixed costs)
- Customers have strong brand preferences and/or loyalty to incumbent sellers.
- Patents and other forms of intellectual property protection are in place.
- There are strong network effects.
- Capital requirements are high.
- There is limited new access to distribution channels and shelf space.
- Government policies are restrictive.
- There are restrictive trade policies.

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COMPETITIVE PRESSURES FROM THE SELLERS OF SUBSTITUTE PRODUCTS

- **Substitute Products Considerations:**
  1. Readily available and attractively priced?
  2. Comparable or better in terms of quality, performance, and other relevant attributes?
  3. Offer lower switching costs to buyers?
- **Indicators of Substitutes' Competitive Strength:**
  - Increasing rate of growth in sales of substitutes
  - Substitute producers adding new output capacity
  - Increasing profitability of substitute producers

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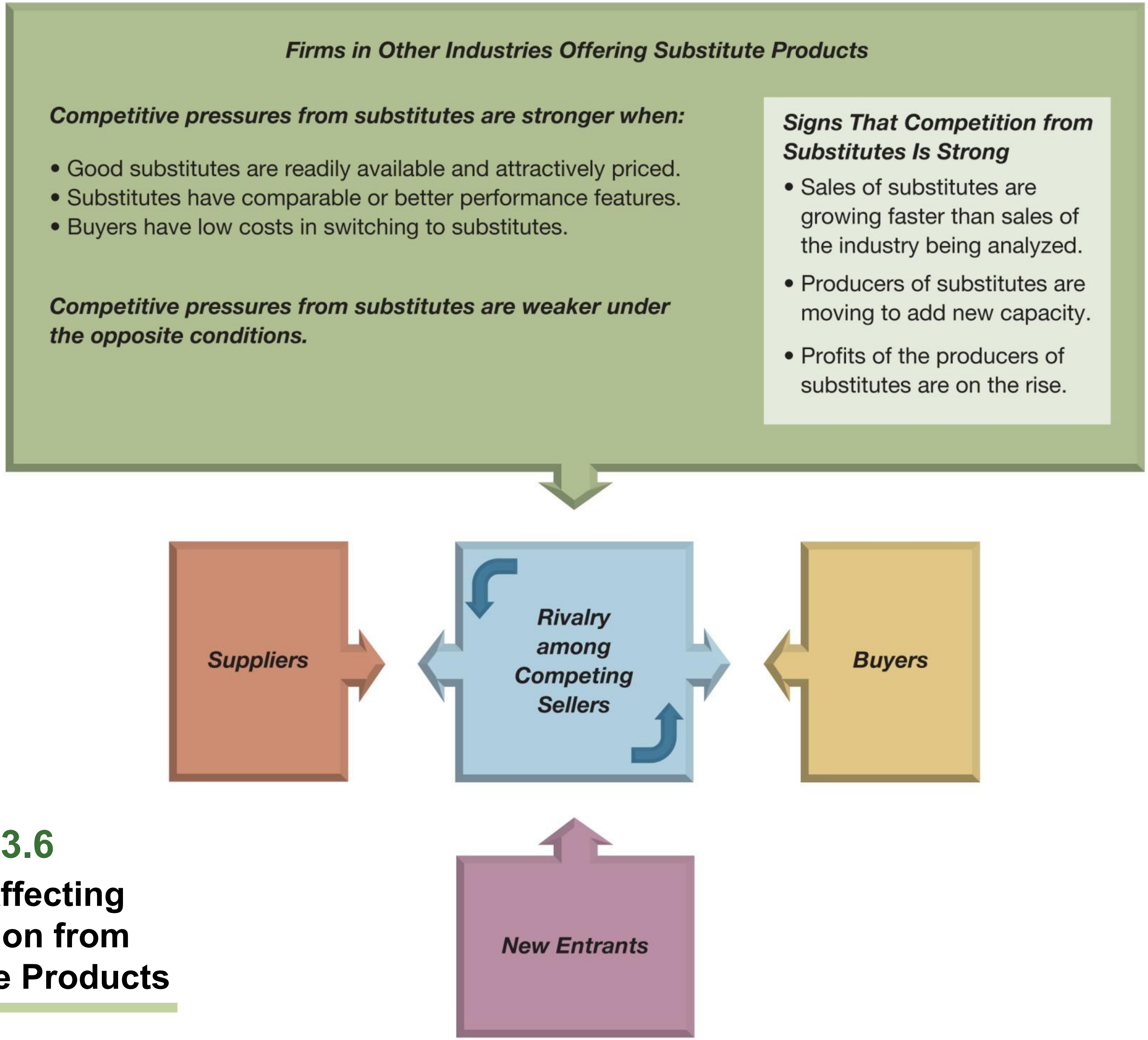

FIGURE 3.6

Factors Affecting Competition from Substitute Products

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COMPETITIVE PRESSURES STEMMING FROM SUPPLIER BARGAINING POWER

- **Supplier Bargaining Power Depends On:**
  - Strength of demand for and availability of suppliers’ products.
  - Whether suppliers provide a differentiated input that enhances the performance of the industry’s product.
  - Industry members’ costs for switching among suppliers
  - Size and number of suppliers relative to industry members
  - Possibility of backward integration into suppliers’ industry
  - Fraction of the cost of the supplier’s product relative to the total cost of the industry’s product
  - Availability of good substitutes for suppliers’ products
  - Whether industry members are major customers of suppliers.

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FIGURE 3.7

Factors Affecting the Bargaining Power of Suppliers

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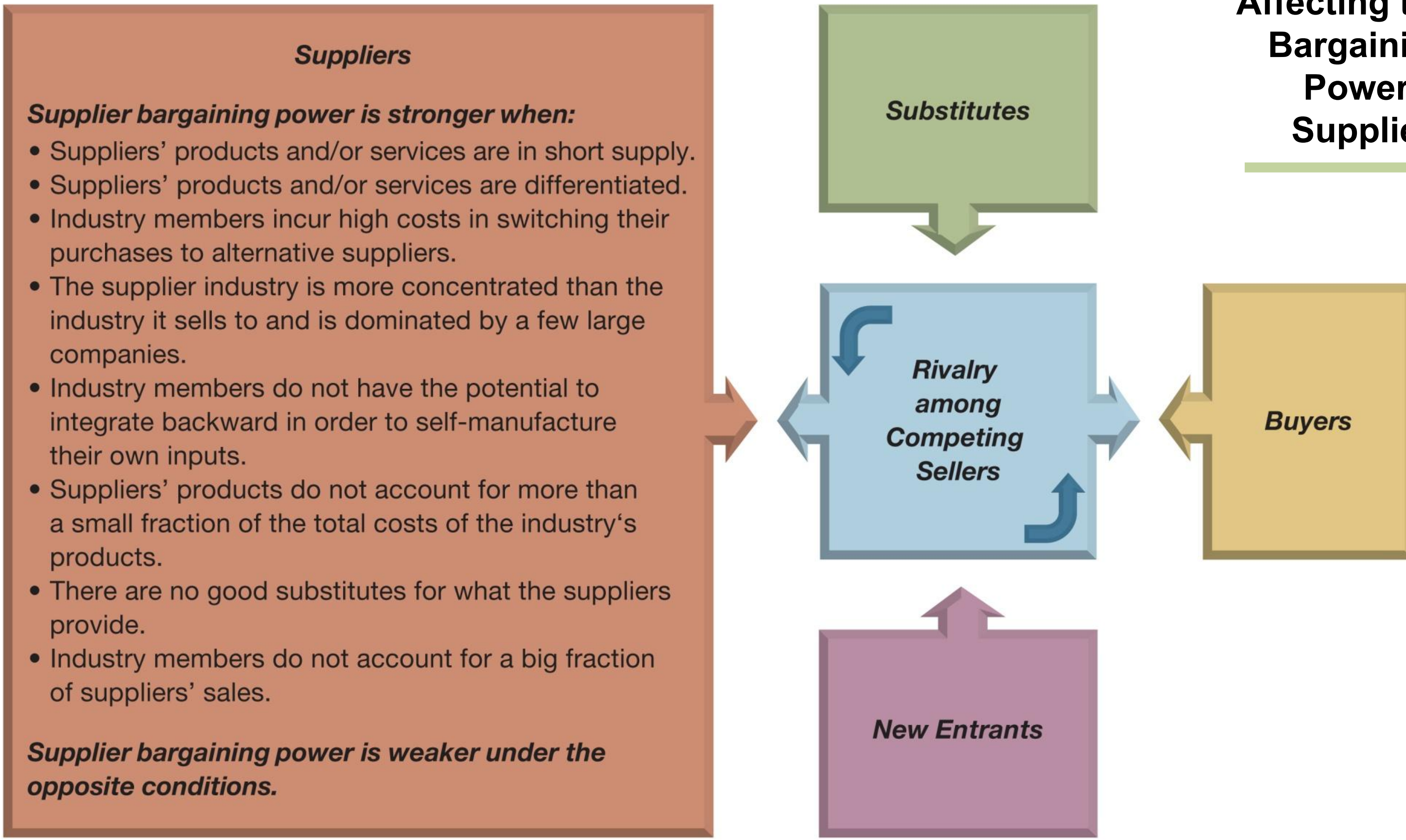

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COMPETITIVE PRESSURES STEMMING FROM BUYER BARGAINING POWER AND PRICE SENSITIVITY

- Buyer Bargaining Power Considerations:
  - Strength of buyers' demand for sellers' products
  - Degree to which industry goods are differentiated
  - Buyers' costs for switching to competing sellers or substitutes
  - Number and size of buyers relative to number of sellers
  - Threat of buyers' integration into sellers' industry
  - Buyers' knowledge of products, costs and pricing
  - Buyers' discretion in delaying purchases
  - Buyers' price sensitivity due to low profits, size of purchase, and consequences of purchase

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FIGURE 3.8

Factors Affecting the Bargaining Power of Buyers

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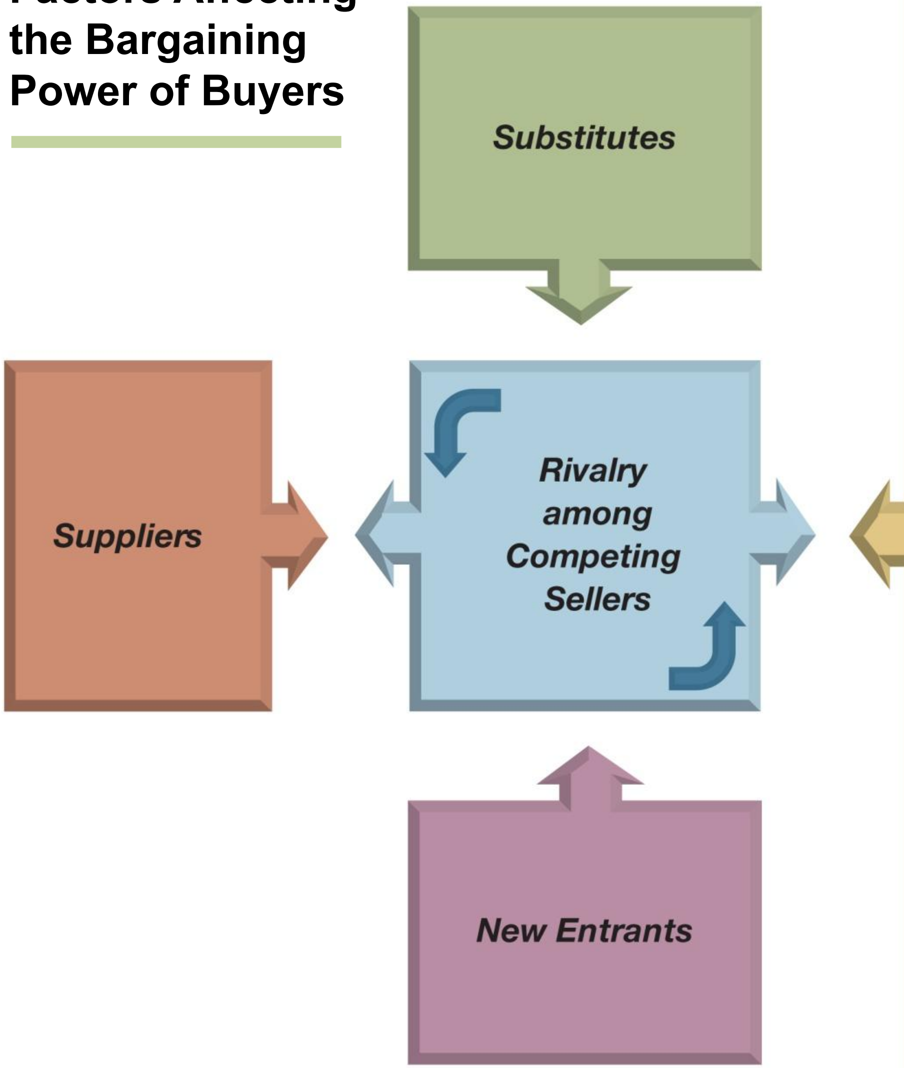

Buyers

Competitive pressures from buyers increase when they have strong bargaining power and are price-sensitive. Buyer bargaining power is stronger when:

- Buyer demand is weak in relation to industry supply.
- The industry's products are standardized or undifferentiated.
- Buyer costs of switching to competing products are low.
- Buyers are large and few in number relative to the number of industry sellers.
- Buyers pose a credible threat of integrating backward into the business of sellers.
- Buyers are well informed about the quality, prices, and costs of sellers.
- Buyers have the ability to postpone purchases.

Buyers are price-sensitive and increase competitive pressures when:

- Buyers earn low profits or low income.
- The product represents a significant fraction of their purchases.

Competitive pressures from buyers decrease and become a weaker force under the opposite conditions.

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IS THE COLLECTIVE STRENGTH OF THE FIVE COMPETITIVE FORCES CONDUCIVE TO GOOD PROFITABILITY?

- Is the state of competition in the industry stronger than “normal”?
- Can industry firms expect to earn decent profits given prevailing competitive forces?
- Are some of the competitive forces sufficiently powerful to undermine industry profitability?
  - Even one powerful force may be enough to make the industry unattractive in terms of its profit potential

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CORE CONCEPT

- The strongest of the five forces determines the extent of the downward pressure on an industry’s profitability.
- Having more than one strong force means that an industry has multiple competitive challenges with which to cope.

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COMPLEMENTORS AND THE VALUE NET

- How the Value Net differs from the Five Forces
  - Focuses on the interactions of industry participants with a particular (focal) company.
  - Defines the category of “competitors” to include the focal firm’s direct competitors, industry rivals, the sellers of substitute products, and potential entrants.
  - Introduces a new category of industry participant—“complementors”—producers of products that enhance the value of the focal firm’s products when they are used together.

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CORE CONCEPT

- **Complementors** are the producers of complementary products, which are products that enhance the value of the focal firm's products when they are used together.

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FIGURE 3.9 The Value Net

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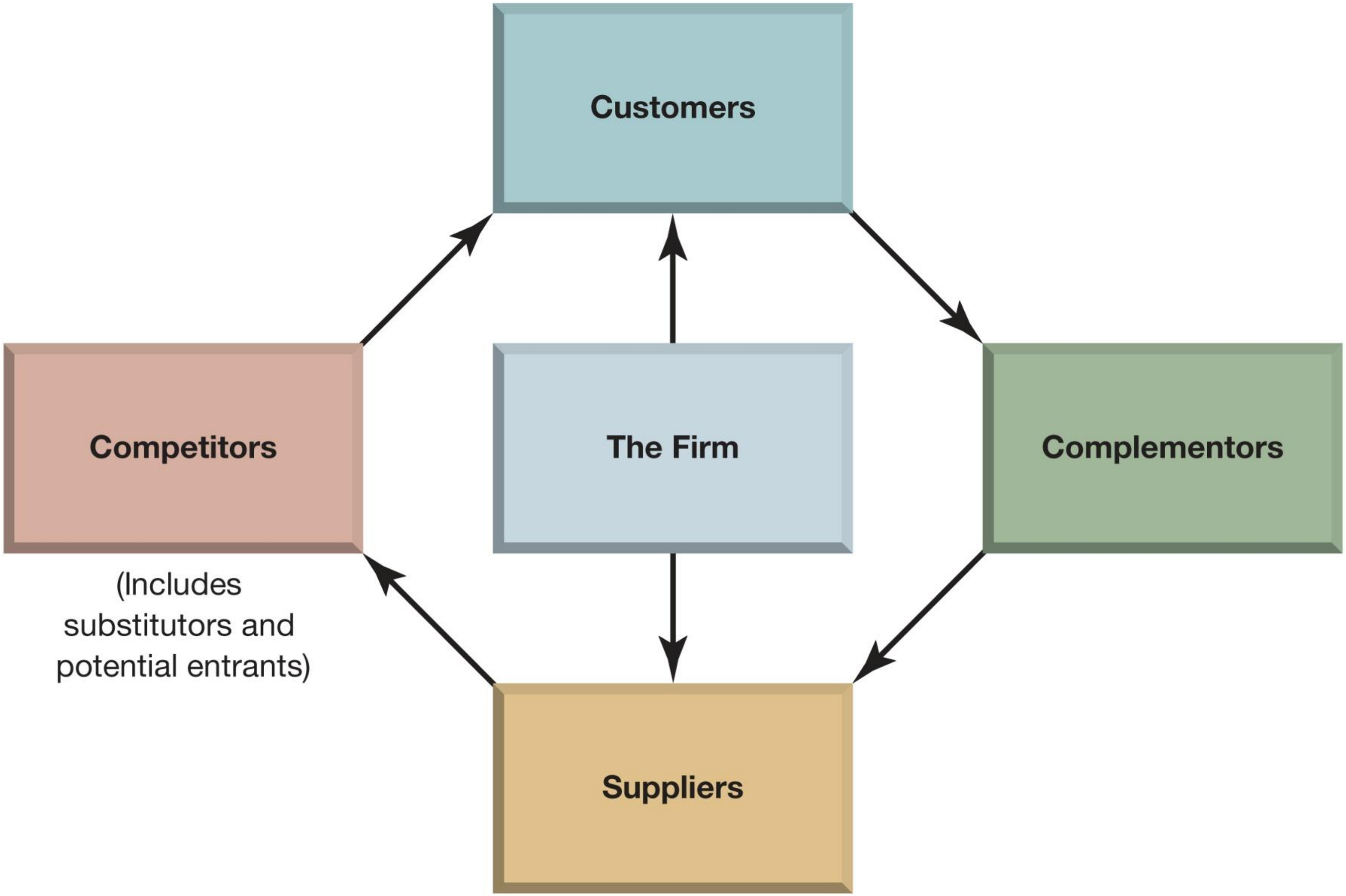

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MATCHING COMPANY STRATEGY TO COMPETITIVE CONDITIONS

Effectively matching a firm's business strategy to prevailing competitive conditions has two aspects:

1. Pursuing avenues that shield the firm from as many competitive pressures as possible.
2. Initiating actions calculated to shift competitive forces in the firm's favor by altering underlying factors driving the five forces.

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STRATEGIC MANAGEMENT PRINCIPLE

- A company's strategy is increasingly effective the more it provides some insulation from competitive pressures, shifts the competitive battle in the company's favor, and positions firms to take advantage of attractive growth opportunities.

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INDUSTRY DYNAMICS AND THE FORCES DRIVING CHANGE

- Driving forces analysis has three steps:
  1. Identifying what the driving forces are.
  2. Assessing whether the drivers of change are, on the whole, acting to make the industry more or less attractive.
  3. Determining what strategy changes are needed to prepare for the impact of the driving forces.

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CORE CONCEPT

- Driving forces are the major underlying causes of change in industry and competitive conditions.

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TABLE 3.3 The Most Common Drivers of Industry Change

- Changes in the long-term industry growth rate
- Increasing globalization
- Emerging new Internet capabilities and applications
- Shifts in buyer demographics
- Technological change and manufacturing process innovation
- Product and marketing innovation
- Entry or exit of major firms
- Diffusion of technical know-how across companies and countries
- Changes in cost and efficiency
- Reductions in uncertainty and business risk
- Regulatory influences and government policy changes
- Changing societal concerns, attitudes, and lifestyles

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STRATEGIC MANAGEMENT PRINCIPLE

- The most important part of driving forces analysis is to determine whether the collective impact of the driving forces will be to increase or decrease market demand, make competition more or less intense, and lead to higher or lower industry profitability.

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ASSESSING THE IMPACT OF THE FACTORS DRIVING INDUSTRY CHANGE

1. Are the driving forces as a whole causing demand for the industry's product to increase or decrease?
2. Is the collective impact of the driving forces making competition more or less intense?
3. Will the combined impacts of the driving forces lead to higher or lower industry profitability?

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STRATEGIC MANAGEMENT PRINCIPLE

- The real payoff of driving-forces analysis is to help managers understand what strategy changes are needed to prepare for the impacts of the driving forces.

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ADJUSTING STRATEGY TO PREPARE FOR THE IMPACTS OF DRIVING FORCES

- What strategy adjustments will be needed to deal with the impacts of the driving forces on industry conditions?
  - What adjustments must be made immediately?
  - What actions currently being taken should be halted or abandoned?
  - What can we do now to prepare for adjustments we anticipate making in the future?

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STRATEGIC GROUP ANALYSIS

- Strategic Group
  - Consists of those industry members with similar competitive approaches and positions in the market:
    - Having comparable product-line breadth
    - Emphasizing the same distribution channels
    - Depending on identical technological approaches
    - Offering the same product attributes to buyers
    - Offering similar services and technical assistance

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CORE CONCEPTS

- A **strategic group** is a cluster of industry rivals that have similar competitive approaches and market positions.
- **Strategic group mapping** is a technique for displaying the different market or competitive positions that rival firms occupy in the industry.

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USING STRATEGIC GROUP MAPS TO ASSESS THE MARKET POSITIONS OF KEY COMPETITORS

- Constructing a strategic group map:
  - Identify the competitive characteristics that delineate strategic approaches used in the industry.
  - Plot the firms on a two-variable map using pairs of the competitive characteristics.
  - Assign firms occupying about the same map location to the same strategic group.
  - Draw circles around each strategic group, making the circles proportional to the size of the group's share of total industry sales revenues.

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TYPICAL VARIABLES USED IN CREATING GROUP MAPS

- Price/quality range (high, medium, low)
- Geographic coverage (local, regional, national, global)
- Product-line breadth (wide, narrow)
- Degree of service offered (no frills, limited, full)
- Distribution channels (retail, wholesale, Internet, multiple)
- Degree of vertical integration (none, partial, full)
- Degree of diversification into other industries (none, some, considerable)

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GUIDELINES FOR CREATING GROUP MAPS

1. Variables selected as map axes should not be highly correlated.
2. Variables should reflect important (sizable) differences among rival approaches.
3. Variables may be quantitative, continuous, discrete and\or defined in terms of distinct classes and combinations.
4. Drawing group circles proportional to the combined sales of firms in each group will reflect the relative sizes of each strategic group.
5. Drawing maps using different pairs of variables will show the different competitive positioning relationships present in the industry’s structure.

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STRATEGIC MANAGEMENT PRINCIPLE

- Strategic group maps reveal which companies are close competitors and which are distant competitors.

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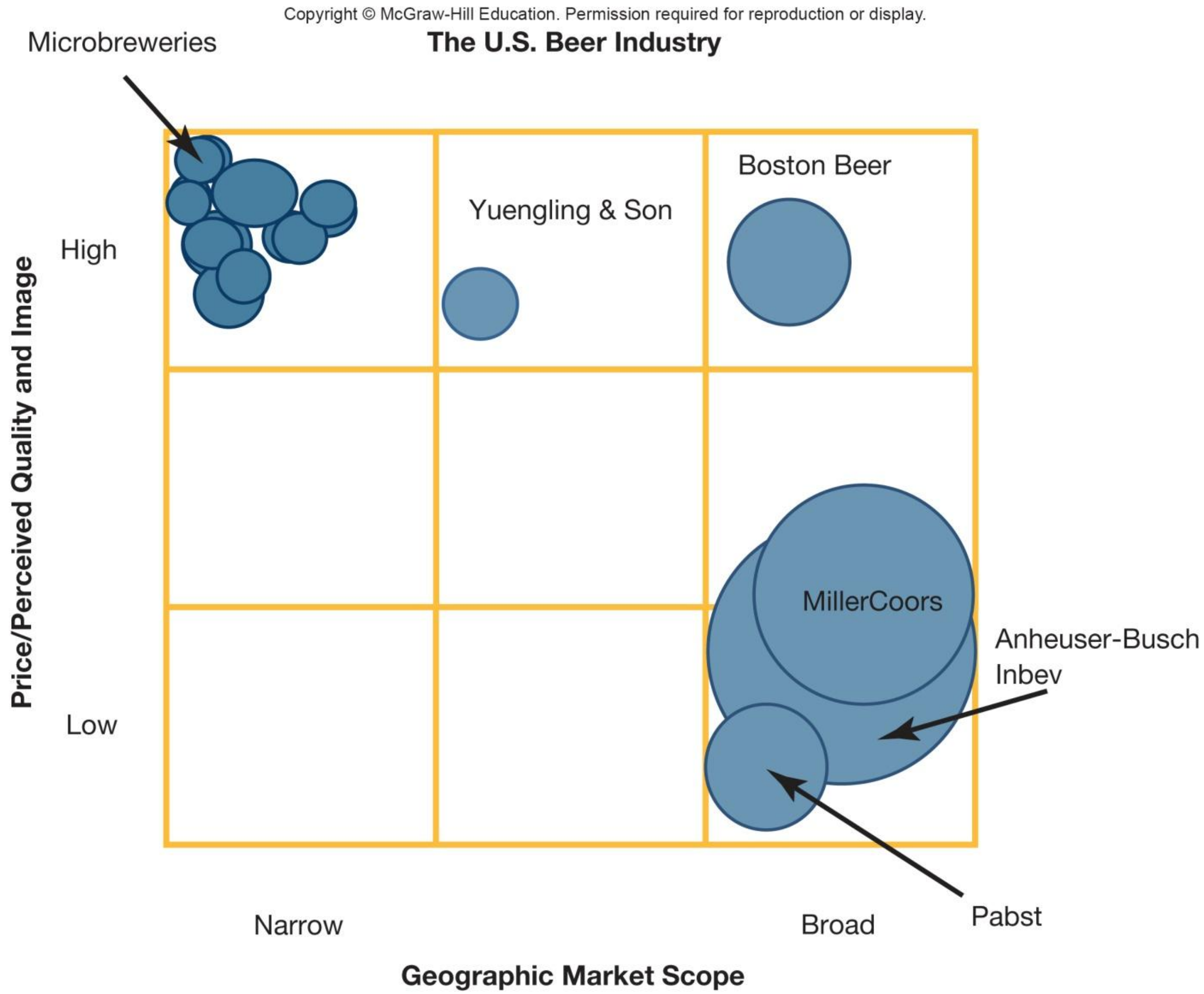
ILLUSTRATION CAPSULE 3.1

Comparative Market Positions of Producers in the U.S. Beer Industry: A Strategic Group Map Example



Footnote: **Circles are drawn roughly proportional to the sizes of the chains, based on revenues.**

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ILLUSTRATION CAPSULE 3.1

Comparative Market Positions of Producers in the U.S. Beer Industry: A Strategic Group Map Example

- Which strategic group is located in the least favorable market position? Which group is in the most favorable position?
- Which strategic group is likely to experience increased intragroup competition?
- Which groups are most threatened by the likely strategic moves of members of nearby strategic groups?

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STRATEGIC MANAGEMENT PRINCIPLE

- Some strategic groups are more favorably positioned than others because they confront weaker competitive forces and/ or because they are more favorably impacted by industry driving forces.

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THE VALUE OF STRATEGIC GROUP MAPS

- Maps are useful in identifying which industry members are close rivals and which are distant rivals.
- Not all map positions are equally attractive:
  1. Prevailing competitive pressures from the industry's five forces may cause the profit potential of different strategic groups to vary.
  2. Industry driving forces may favor some strategic groups and hurt others.

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COMPETITOR ANALYSIS

- Competitive Intelligence
  - Information about rivals that is useful in anticipating their next strategic moves.
- Signals of the Likelihood of Strategic Moves:
  - Rivals under pressure to improve financial performance
  - Rivals seeking to increase market standing
  - Public statements of rivals' intentions
  - Profiles developed by competitive intelligence units

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STRATEGIC MANAGEMENT PRINCIPLE

- Studying competitors’ past behavior and preferences provides a valuable assist in anticipating what moves rivals are likely to make next and outmaneuvering them in the marketplace.

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FIGURE 3.10 A Framework for Competitor Analysis

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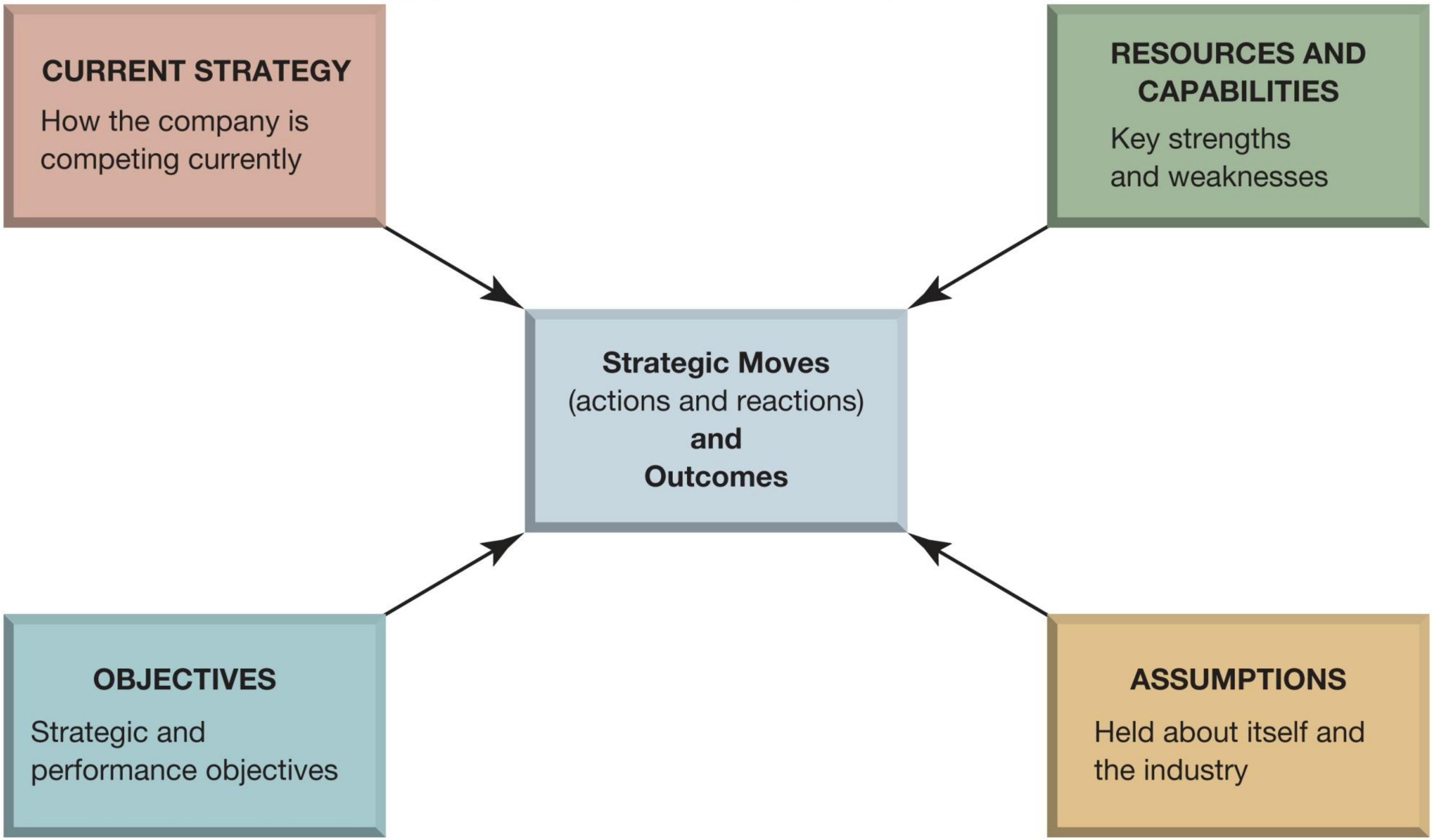

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A FRAMEWORK FOR COMPETITOR ANALYSIS

- Indicators of a rival firm's likely strategic moves and countermoves:
  - The rival firm's current strategy
  - The rival firm's objectives
  - The rival firm's capabilities
  - The rival firm's assumptions about itself and its industry

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USEFUL QUESTIONS TO HELP PREDICT THE LIKELY ACTIONS OF IMPORTANT RIVALS

- Which competitors’ strategies are achieving good results?
- Which competitors are losing in the marketplace or badly need to increase unit sales and market share?
- Which rivals are likely make major moves to enter new geographic markets or to increase sales and market share in a particular geographic region?
- Which rivals can expand product offerings to enter new product segments where they do not have a presence?
- Which rivals can be acquired? Which rivals are financially able and looking to make an acquisition?

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CREATING A STRATEGIC PROFILE OF A RIVAL COMPETITOR FIRM

- Current Strategy
  - How is the competitor positioned in the market?
  - What is the basis for its competitive advantage?
  - What kinds of investments is it making (as an indicator of its expected growth trajectory)?
- Objectives
  - What are its financial performance objectives?
  - What are its strategic objectives?
  - How well is it performing in meeting its objectives?
  - Is it under pressure to improve its performance?

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CREATING A STRATEGIC PROFILE OF A RIVAL COMPETITOR FIRM (cont'd)

- **Capabilities**
  - What are the competitor's current capabilities?
  - What weaknesses does it have?
  - Which capabilities is it making efforts to obtain?
- **Assumptions**
  - What do the competitor's top managers believe about their strategic situation?
  - How will their beliefs affect the competitor's behavior in the market?

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KEY SUCCESS FACTORS

- Key Success Factors (KSFs)
  - Are the strategy elements, product and service attributes, operational approaches, resources, and competitive capabilities that are necessary for competitive success by any and all firms in an industry.
  - Vary from industry to industry, and over time within the same industry, and in importance as drivers of change and competitive conditions change.

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CORE CONCEPT

- **Key success factors** are the strategy elements, product and service attributes, operational approaches, resources, and competitive capabilities that are essential to surviving and thriving in the industry.

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IDENTIFICATION OF KEY SUCCESS FACTORS

1. On what basis do buyers of the industry's product choose between the competing brands of sellers? That is, what product attributes and service characteristics are crucial to competitive success?
2. Given the nature of competitive rivalry prevailing in the marketplace, what resources and competitive capabilities must a firm have to be competitively successful?
3. What shortcomings are almost certain to put a firm at a significant competitive disadvantage?

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THE INDUSTRY OUTLOOK FOR PROFITABILITY

- An industry environment is fundamentally attractive if it presents a company with good opportunity for above-average profitability.
- An industry environment is fundamentally unattractive if a firm's profit prospects in the industry are unappealingly low.

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FACTORS TO CONSIDER IN ASSESSING INDUSTRY ATTRACTIVENESS

- How the firm is being impacted by the state of the macro-environment.
- Whether strong competitive forces are squeezing industry profitability to subpar levels.
- Whether the presence of complementors and the possibility of cooperative actions improve the company's prospects.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- Whether the firm occupies a stronger market position than rivals.
- Whether this is likely to change in the course of competitive interactions.
- How well the firm's strategy delivers on industry key success factors.

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STRATEGIC MANAGEMENT PRINCIPLE

- The degree to which an industry is attractive or unattractive is not the same for all industry participants and all potential entrants.

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INDUSTRY ATTRACTIVENESS IS NOT THE SAME FOR ALL PARTICIPANTS

- Industry outsiders may conclude that they have the resources to easily hurdle the barriers to entering an attractive industry while other outsiders may find the same industry unattractive because they do not want to challenge market leaders and have better opportunities elsewhere.

  A particular industry's attractiveness depends in large part on whether a company has the resources and capabilities to be competitively successful and profitable in that environment.

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WHAT SHOULD A CURRENT COMPETITOR DECIDE ABOUT ITS INDUSTRY?

- When a competitor decides an industry is attractive, it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business.
- When a strong competitor concludes its industry is relatively unattractive and lacking in opportunity, it may elect to protect its present position, investing cautiously if at all and looking for opportunities in other industries.
- A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business.

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