Chapter 2

Analysis of the External Environment

Management of Strategy
Concepts and Cases

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Knowledge Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

1. Explain the importance of analyzing and understanding the firm’s external environment.
2. Define and describe the general environment and the industry environment.
3. Discuss the four activities of the external environmental analysis process.
4. Name and describe the general environment’s six segments.
5. Identify the five competitive forces and explain how they determine an industry’s profit potential.
Studying this chapter should provide you with the strategic management knowledge needed to:

6. Define strategic groups and describe their influence on the firm.

7. Describe what firms need to know about their competitors and different methods (including ethical standards) used to collect intelligence about them.
FIGURE 2.1 The External Environment

The External Environment

- Economic
- Demographic
- Sociocultural
- Political/Legal
- Global
- Technological

Industry Environment
- Threat of New Entrants
- Power of Suppliers
- Power of Buyers
- Product Substitutes
- Intensity of Rivalry

Competitor Environment
<table>
<thead>
<tr>
<th>Segment</th>
<th>Elements</th>
<th>Elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demographic Segment</td>
<td>• Population size</td>
<td>• Ethnic mix</td>
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<td></td>
<td>• Age structure</td>
<td>• Income distribution</td>
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<td></td>
<td>• Geographic distribution</td>
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<tr>
<td>Economic Segment</td>
<td>• Inflation rates</td>
<td>• Personal savings rate</td>
</tr>
<tr>
<td></td>
<td>• Interest rates</td>
<td>• Business savings rates</td>
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<tr>
<td></td>
<td>• Trade deficits or surpluses</td>
<td>• Gross domestic product</td>
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<tr>
<td></td>
<td>• Budget deficits or surpluses</td>
<td></td>
</tr>
<tr>
<td>Political/Legal Segment</td>
<td>• Antitrust laws</td>
<td>• Labor training laws</td>
</tr>
<tr>
<td></td>
<td>• Taxation laws</td>
<td>• Educational philosophies and policies</td>
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<td>• Deregulation philosophies</td>
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<tr>
<td>Sociocultural Segment</td>
<td>• Women in the workforce</td>
<td>• Concerns about the environment</td>
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<td></td>
<td>• Workforce diversity</td>
<td>• Shifts in work and career preferences</td>
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<tr>
<td></td>
<td>• Attitudes about the quality of work life</td>
<td>• Shifts in preferences regarding product and service characteristics</td>
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<tr>
<td>Technological Segment</td>
<td>• Product innovations</td>
<td>• Focus of private and government-supported R&amp;D expenditures</td>
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<td>• Applications of knowledge</td>
<td>• New communication technologies</td>
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<td>Global Segment</td>
<td>• Important political events</td>
<td>• Newly industrialized countries</td>
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<td>• Different cultural and institutional attributes</td>
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</table>
Industry Environment

• The set of factors directly influencing a firm and its competitive actions and competitive responses

  ➢ Threat of new entrants
  ➢ Power of suppliers
  ➢ Power of buyers
  ➢ Threat of product substitutes
  ➢ Intensity of rivalry among competitors
Competitor Analysis

• Gathering and interpreting information about all of the companies that the firm competes against.
• Understanding the firm’s competitor environment complements the insights provided by studying the general and industry environments.
Analysis of the External Environments

• General environment
  ➢ Focused on the future

• Industry environment
  ➢ Focused on factors and conditions influencing a firm’s profitability within an industry

• Competitor environment
  ➢ Focused on predicting the dynamics of competitors’ actions, responses and intentions
<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
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<tbody>
<tr>
<td>Scanning</td>
<td>Identifying early signals of environmental changes and trends</td>
</tr>
<tr>
<td>Monitoring</td>
<td>Detecting meaning through ongoing observations of environmental changes and trends</td>
</tr>
<tr>
<td>Forecasting</td>
<td>Developing projections of anticipated outcomes based on monitored changes and trends</td>
</tr>
<tr>
<td>Assessing</td>
<td>Determining the timing and importance of environmental changes and trends for firms’ strategies and their management</td>
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Opportunities and Threats

• **Opportunity**
  
  ➢ A condition in the general environment that, if exploited, helps a company achieve strategic competitiveness.

• **Threat**
  
  ➢ A condition in the general environment that may hinder a company’s efforts to achieve strategic competitiveness.
Segments of the General Environment

- The Demographic Segment
  - Population size
  - Age structure
  - Geographic distribution
  - Ethnic mix
  - Income distribution
Segments of the General Environment (cont’d)

• The Economic Segment
  ➢ Inflation rates
  ➢ Interest rates
  ➢ Trade deficits or surpluses
  ➢ Budget deficits or surpluses
  ➢ Personal savings rate
  ➢ Business savings rates
  ➢ Gross domestic product
Segments of the General Environment (cont’d)

• The Political/Legal Segment
  - Antitrust laws
  - Taxation laws
  - Deregulation philosophies
  - Labor training laws
  - Educational philosophies and policies
Segments of the General Environment
(cont’d)

• The Sociocultural Segment

  ➢ Women in the workplace
  ➢ Workforce diversity
  ➢ Attitudes about quality of worklife
  ➢ Concerns about environment
  ➢ Shifts in work and career preferences
  ➢ Shifts in product and service preferences
Segments of the General Environment (cont’d)

• The Technological Segment
  - Product innovations
  - Applications of knowledge
  - Focus of private and government-supported R&D expenditures
  - New communication technologies
Segments of the General Environment (cont’d)

• The Global Segment
  - Important political events
  - Critical global markets
  - Newly industrialized countries
  - Different cultural and institutional attributes
Industry Environment Analysis

• Industry Defined

➢ A group of firms producing products that are close substitutes

• Firms that influence one another

• Includes a rich mix of competitive strategies that companies use in pursuing strategic competitiveness and above-average returns
Threat of New Entrants: Barriers to Entry

- Economies of scale
- Product differentiation
- Capital requirements
- Switching costs
- Access to distribution channels
- Cost disadvantages independent of scale
- Government policy
- Expected retaliation
Barriers to Entry

• Economies of Scale
  ➢ Marginal improvements in efficiency that a firm experiences as it incrementally increases its size

• Factors (advantages and disadvantages) related to large- and small-scale entry
  ➢ Flexibility in pricing and market share
  ➢ Costs related to scale economies
  ➢ Competitor retaliation
Barriers to Entry (cont’d)

• **Product differentiation**
  - Unique products
  - Customer loyalty
  - Products at competitive prices

• **Capital Requirements**
  - Physical facilities
  - Inventories
  - Marketing activities
  - Availability of capital

• **Switching Costs**
  - One-time costs customers incur when they buy from a different supplier
    - New equipment
    - Retraining employees
    - Psychic costs of ending a relationship

• **Access to Distribution Channels**
  - Stocking or shelf space
  - Price breaks
  - Cooperative advertising allowances
Barriers to Entry (cont’d)

• Cost Disadvantages Independent of Scale
  - Proprietary product technology
  - Favorable access to raw materials
  - Desirable locations

• Government policy
  - Licensing and permit requirements
  - Deregulation of industries

• Expected retaliation
  - Responses by existing competitors may depend on a firm’s present stake in the industry (available business options)
Bargaining Power of Suppliers

• **Supplier power increases when:**
  - Suppliers are large and few in number.
  - Suitable substitute products are not available.
  - Individual buyers are not large customers of suppliers and there are many of them.
  - Suppliers’ goods are critical to the buyers’ marketplace success.
  - Suppliers’ products create high switching costs.
  - Suppliers pose a threat to integrate forward into buyers’ industry.
Bargaining Power of Buyers

• **Buyer power increases when:**

  - Buyers are large and few in number.
  - Buyers purchase a large portion of an industry’s total output.
  - Buyers’ purchases are a significant portion of a supplier’s annual revenues.
  - Buyers’ switching costs are low.
  - Buyers can pose threat to integrate backward into the sellers’ industry.
Threat of Substitute Products

- The threat of substitute products increases when:
  - Buyers face few switching costs.
  - The substitute product’s price is lower.
  - Substitute product’s quality and performance are equal to or greater than the existing product.

- Differentiated industry products that are valued by customers reduce this threat.
Intensity of Rivalry Among Competitors

- **Industry rivalry increases when:**
  - There are numerous or equally balanced competitors.
  - Industry growth slows or declines.
  - There are high fixed costs or high storage costs.
  - There is a lack of differentiation opportunities or low switching costs.
  - When the strategic stakes are high.
  - When high exit barriers prevent competitors from leaving the industry.
Interpreting Industry Analyses

- Low entry barriers
- Suppliers and buyers have strong positions
- Strong threats from substitute products
- Intense rivalry among competitors

Unattractive Industry

Low profit potential
Interpreting Industry Analyses (cont’d)

- High entry barriers
- Suppliers and buyers have weak positions
- Few threats from substitute products
- Moderate rivalry among competitors

Attractive Industry

High profit potential
Strategic Groups

• Strategic Group Defined

  ➢ A set of firms emphasizing similar strategic dimensions and using similar strategies

  • Internal competition between strategic group firms is greater than between firms outside that strategic group.

  • There is more heterogeneity in the performance of firms within strategic groups.
    – Similar market positions
    – Similar products
    – Similar strategic actions
Strategic Groups

• Strategic Dimensions

  ➢ Extent of technological leadership
  ➢ Product quality
  ➢ Pricing Policies
  ➢ Distribution channels
  ➢ Customer service
Competitor Analysis

• Competitor Intelligence

➢ The ethical gathering of needed information and data that provides insight into:

• A competitor’s direction (future objectives)
• A competitor’s capabilities and intentions (current strategy)
• A competitor’s beliefs about the industry (its assumptions)
• A competitor’s capabilities
FIGURE 2.2
Competitor Analysis Components

**Future objectives**
- How do our goals compare with our competitors’ goals?
- Where will emphasis be placed in the future?
- What is the attitude toward risk?

**Current strategy**
- How are we currently competing?
- Does this strategy support changes in the competitive structure?

**Assumptions**
- Do we assume the future will be volatile?
- Are we operating under a status quo?
- What assumptions do our competitors hold about the industry and themselves?

**Capabilities**
- What are our strengths and weaknesses?
- How do we rate compared to our competitors?

**Response**
- What will our competitors do in the future?
- Where do we hold an advantage over our competitors?
- How will this change our relationship with our competitors?
Competitor Analysis (cont’d)

Future Objectives

- How do our goals compare with our competitors’ goals?
- Where will the emphasis be placed in the future?
- What is the attitude toward risk?
Competitor Analysis (cont’d)

Future Objectives

Current Strategy

• How are we currently competing?
• Does this strategy support changes in the competitive structure?
Competitor Analysis (cont’d)

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- What are our strengths and weaknesses?
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Competitor Analysis (cont’d)

- What will our competitors do in the future?
- Where do we hold an advantage over our competitors?
- How will this change our relationship with our competitors?
Complementors

• Complementors

➢ The network of companies that sell complementary products or services or are compatible with the focal firm’s own product or service.

  • If a complementor’s product or service adds value to the sale of the focal firm’s product or service, it is likely to create value for the focal firm.

  • However, if a complementor’s product or service is in a market into which the focal firm intends to expand, the complementor can represent a formidable competitor.
Ethical Considerations

• Practices considered both legal and ethical:
  - Obtaining publicly available information
  - Attending trade fairs and shows to obtain competitors’ brochures, view their exhibits, and listen to discussions about their products

• Practices considered both unethical and illegal:
  - Blackmail
  - Trespassing
  - Eavesdropping
  - Stealing drawings, samples, or documents