CRAM

THE EXCLUSIVE NOTE COMPANY

Business Management

Block 2: Evaluating a Company's External Environment

The Strategically Relevant Factors in the Company's Macro-Environment

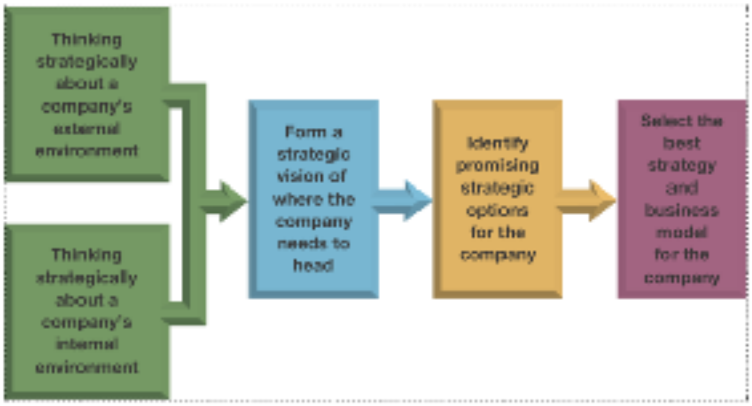
- **Every company operates in a broad Macro-Environment that compromises Six Principal Components:**
    - Political Factors;
    - Economic Conditions;
    - Sociocultural Forces;
    - Technological Factors;
    - Environmental Factors; and
    - Legal Conditions
- Each of these components have the potential to affect the firm's more immediate industry and competitive environment, although some are likely to have a more important effect than others
- An analysis of the impact of these factors is often referred to as PESTEL analysis

Core Concept:

- The **macro-environment** encompasses the broad environmental context in which a company's industry is situated
- **PESTEL Analysis** can be used to assess the strategic relevance of the six principal components of the macro-environment; Political, Economic, Social, Technological, Environmental and Legal

- Since macro-economic factors affect different industries differently it is important for managers to determine which of these represent the most strategically relevant factors outside the firms boundaries

FIGURE 2.1 From Thinking Strategically about the Company's Situation to Choosing a Strategy



- By strategically relevant we mean important enough to have a bearing on the decisions the company ultimately makes about its long-term directions, objectives, strategy and business model

Company's Macro-Environment

- As managers scan the external environment they must be alert for potentially important outer ring developments, asses their impact and influence and adapt the company's direction and strategy

FIGURE 2.2 The Components of a Company's Macro-Environment

Assessing the Company's Industry and Competitive Framework

- Thinking strategically about a company's industry and competitive environment entails using some well-validated concepts and analytic tools
- These include the Five Forces Framework, the Value-Net, Driving Forces, Strategic Groups, Competitor Analysis and Key Success Factors

- Proper use of these tools can provide managers with the understanding needed to create a strategy that fits the company's situation in their environment

The Six Components of the Marco-Environment

Component	Description
Political Factors	These factors include political policies, including the extent to which government intervenes in the economy. They include matters such as fiscal policy, tax policy, the political climate and the strength of institutional systems like the banking system. Some political policies affect certain types of industries more than others.
Economic Conditions	These conditions include the economic climate and specific fraction such as interest rates, exchange rates and the unemployment rate. Economic conditions also includes the climate of the stock market which can influence investor confidence.
Sociocultural Forces	Sociocultural forces include societal values, attitudes, cultural influences and lifestyles that impact demand for particular goods, as well as demographic factors such as population size and growth rate as well as age distribution. These factors vary and change over time.
Technological Factors	These factors include the pace of technological change and developments that have the potential for wide-ranging effects on society such as generic engineering or nanotechnology. They include institutions involved in creating new knowledge and controlling the use of technology, such as R&D, university sponsored tech incubators and control over the Internet.
Environmental Forces	These include ecological and environmental forces such as weather, climate and climate change and water shortages. These factors can directly impact industries such as insurance, farming and tourism. They may have an indirect but substantial effect on other industries like transportation or utilities

Component	Description
Legal and Regulatory Frameworks	These factors include the laws with which companies must comply, such as consumer laws or labour laws. Some factors such as financial service regulation are industry specific. Others like minimum wage legislation affect certain types of industries more than others

The Five Forces Framework

- The character and strength of the competitive forces operating in an industry are never the same from one to the other
- The most powerful and widely used tool for diagnosing the principal competitive pressures in a market is the Five Forces Framework

- **The figure depicts that competitive forces on a company comes from five sources**
  1. Competition from Rival Sellers;
  2. Competition from Potential New Entrants to the Industry;
  3. Competition from Producers of Substitute Products;
  4. Supplier bargaining power; and
  5. Customer bargaining power
- **Using the Five Forces model to determine the nature and strength of competitive pressures involves three steps:**
  1. **Step 1:** For each of the Five Forces, identify the different parties involved, along with the specific factors that bring about competitive pressures

2. **Step 2:** Evaluate how strong the pressures stemming from each of the Five Forces are
3. **Step 3:** Determine whether the Five Forces, overall, are supportive of high industry profitability

Competitive Pressures Created by the Rivalry among Competing Sellers:

- The strongest of the Five Forces is often the rivalry for a buyer patronage among competing sellers of a product or service
- The intensity of rivalry among competing sellers within an industry depends on a number of identifiable factors
- **A brief explanation of why these factors affect the degree of rivalry is in order:**
    1. Rivalry increases when buyer demand is growing slowly or declining
    2. Rivalry increases as it becomes less costly for buyers to switch brands
    3. Rivalry increases as the products of rival sellers become less strongly differentiated
    4. Rivalry is more intense when industry members have too much inventory or significant amounts of idle production capacity, especially if the industry's product entails high fixed costs or high storage costs
    5. Rivalry intensifies as the number of competitors increases and they become more equal in size and capability
    6. Rivalry becomes more intense as the diversity of competitors increases in terms of long-term directions, objectives, strategies and countries of origin
    7. Rivalry is stronger when high exit barriers keep unprofitable firms from leaving the industry
- When rivalry is strong the battle for market share is so vigorous that the profit margins of most industry members are squeezed to very low levels
- When rivalry is moderate, a more normal state, the manoeuvring among industry members, still allows most industry members to earn acceptable profits

- When rivalry is weak, most companies in the industry are relatively well satisfied with their sales growth and market shares and rarely undertake offensives to steal customers away
- Weak rivalry also means that there is no downward pressure on industry profitability due to this particular competitive force

Competitive Pressures Associated with the Threat of New Entrants:

- New entrants into an industry threaten the position of rival firms since they will compete for a market share, add to the number of industry rivals and add to the industry's production capacity
- **Just how serious the threat of entry is in a particular market depends on two classes of factors:**
    1. The expected reaction of incumbent firms to new entry; and
    2. What are known as barriers to entry
- The threat is low in industries where firms are likely to retaliate against new entrants by discounting prices and other moves to make entry unprofitable
- The threat of entry is low when entry barriers are high
- **Things to consider with regard to Entry Threats:**
    - The expected reactions of incumbent firms
    - The strength of barriers to entry
    - The attractiveness of a particular markets growth in demand and profit potential
    - The capabilities and resources of potential entrants
    - Entry of existing competitors into market segments in which they have no current presence
- **Entry Barriers are High under the following conditions:**
    1. There are sizeable economies of scale in production, distribution, advertising or other activities
    2. Incumbents have other hard to replicate cost advantages over new entrants
    3. Customers have strong brand preferences and high degrees of loyalty to the seller
    4. Patents and other forms of intellectual property protection are in place

5. There are strong network effects in customer demand
6. Capital requirements are high
7. There are difficulties in building a network of distributors/dealers or in securing adequate space on retailers shelves
8. There are restrictive regulatory policies
9. There are restrictive trade policies

- It is important to recognise that the barriers to entering an industry can become stronger or weaker over time

Competitive Pressures from the Sellers of Substitute Products:

- Companies in one industry are vulnerable to competitive pressures from the actions of companies in a closely adjoining industry whenever buyers view the products of the two industries as good substitutes
- Three Factors determine whether the competitive pressures from substitute products are strong or weak
- **Competitive Pressures are stronger when:**
    1. Good substitutes are readily available and attractively priced;
    2. Buyers view the substitutes as comparable or better in terms of quality, performance and other relevant attributes;
    3. The costs that a buyer has to incur in switching to the substitutes are low
- **Signs that Competition from Substitutes is Strong:**
    1. Sales of substitutes are growing faster than sales of the industry being analysed
    2. Producers of substitutes are moving to add new capacity
    3. Profits of the producers of substitutes are on the rise
- **Before assessing the competitive pressures coming from substitutes, company managers must identify the substitutes, this involves;**
    - Determining where the industry boundaries lie, and
    - Figuring out which other products can address the same basic customer needs

Competitive Pressures Stemming from Supplier Bargaining Power:

- Whether the suppliers of industry members represent a weak or strong competitive force depends on whether the suppliers have sufficient bargaining power
- Suppliers with strong bargaining power are a source of competitive pressure because of their ability to charge industry members higher prices, pass costs to them and limit their opportunities to better deals
- Small scale retailers often must contend with the power of manufacturers of well known brands
- The manufactures have a degree of power in this regard because customers expect those items to be on the retailers shelves
- **Supplier's Power is Stronger when:**
    1. The Demand for Supplier's products are high and the products are in short supply
    2. Supplier provides differential inputs that enhance the performance of the industry's product
    3. It is difficult or costly for industry members to switch their purchases from one supplier to another
    4. The supplier industry is dominated by a few large companies and it is more concentrated that the industry it sells to
    5. Industry members are incapable of integrating backward to self-manufacture items they have been buying from Suppliers
    6. Suppliers provide an item that accounts fo no more than a small fraction of their costs of the industry's product
    7. Good substitutes are not available for the suppliers products
    8. Industry members are not major customers of suppliers

- When identifying the degree of supplier power it is important to note that different types of suppliers have different amounts of bargaining power
- The first step is to identify the different types of suppliers, following which to asses the bargaining power of each one

Competitive Pressures Stemming from Buyer Bargaining Power and Price Sensitivity:

- Whether buyers are able to exert strong competitive pressures on industry members depends on the degree to which buyers have bargaining power and the extent to which they are price sensitive
- Buyers with strong bargaining power can limit industry profitability by demanding price recessions, better payment terms or additional features and services at the cost of industry members
- Buyer price sensitivity limits the profit of industry members by restricting the ability of sellers to raise prices without losing revenue due to lost sales
- **Buyer Bargaining Power is Stronger when:**
    1. Buyer demand is weak in relation to the available supply
    2. Industry goods are standardised or differentiation is weak
    3. Buyers costs of switching to competing brand or substitutes are relatively low
    4. Buyers are large and few in number relative to the number of sellers
    5. Buyers pose a credible threat of integrating backward into the business of sellers
    6. Buyers are well informed about the product offerings of sellers (features) and the cost of production (indication of markup)
    7. Buyers have the discretion to delay their purchases or perhaps not even make a purchase at all
- **The following factors increase Buyer Price Sensitivity and result in greater competitive pressures:**
    1. Buyer price sensitivity increases when buyers are earring low profits or have low income
    2. Buyers are more price-sensitive if the product represents a large faction of their total purchases
- The starting point for the analysis of buyers as a competitive force is to identify the different types of buyers along the value chain then proceed to analysing the bargaining power and price sensitivity of each one

- Not all buyers have the equal degrees of bargaining power and some may be less sensitive than others to price, quality or service differences

Is the Collective Strength of the Five Competitive Forces Conducive to Good Profitability:

- The most extreme case of a completely unattractive industry occurs when all five forces exhibit strong competitive pressures
- Rivalry among sellers is vigorous, low entry barriers allow new rivals to gain a market foothold, competition from substitutes are intense, and both suppliers and buyers are able to exercise considerable leverage
- Strong competitive forces coming from all five directions drive profitability into the ground, produces frequent losses for industry members and even puts some out of business
- An industry can also be completely unattractive without all five forces being strong
- In fact intense competitive pressures from just one of the five forces may suffice to destroy the conditions for good profitability and prompt some companies to exit the business
- The strongest competitive forces determine the extent of the competitive pressure on industry profitability
- The ideal competitive environment for earning good profits is one where both buyers and suppliers are in weak bargaining positions, there are no good substitutes, high-barriers block further entry and rivalry amongst sellers is muted

Matching Company Strategy to Competitive Conditions:

- Working through the Five Forces model not only aids strategy makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better company strategy to the character of the marketplace
- **Effectively matching a company'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 the competitive forces in the company's favour by altering the underlying factors driving the five forces

- But making headway on these two fronts requires identifying competitive pressures, gauging the restive strength of each of the five competitive forces, and gaining a deep enough understanding to the state of competition in the industry to know which buttons to push

Complementors and the Value Net

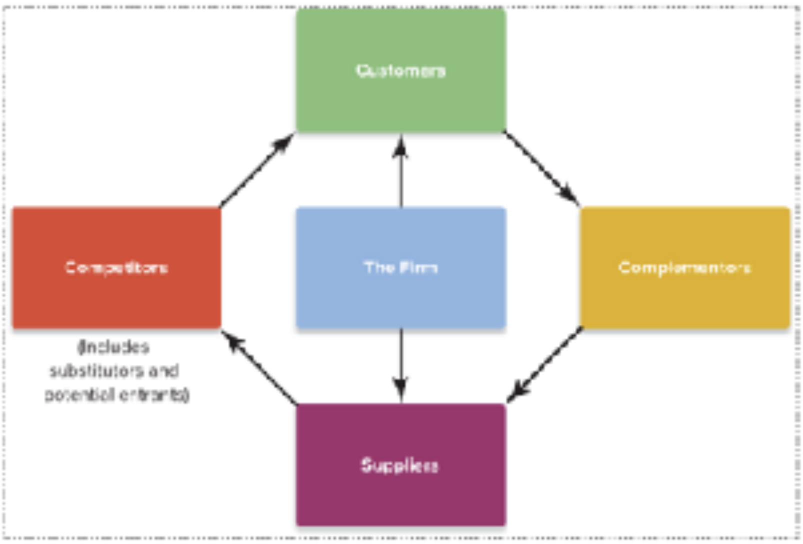
Core Concept:

- Complementors are the producers of complementary products which are products that enhance the value of the local firms products when they are used together

- Not all interactions amongst industry participants are competitive in nature
- Some have the potential to be cooperative, as the value net framework demonstrates
- **Like the five forces framework, the value net includes an analysis of buyers, suppliers and substitutes, it differs from the five forces framework in several important ways**
    1. First, the analysis focusses on the interactions of industry participants with a particular company, thus it places that firm in the centre of the framework
    2. Second, the category of competitors is defined to include not only the local firms direct competitors or industry rivals but also the sellers of substitute products
    3. Third, the value net framework introduces a new category of industry participants not found in the five forces framework - Complementors
    - The inclusion of Complementors draws particular attention to the fact that success in the marketplace need not come at the expense of others
- Interactions among industry participants may be cooperative in nature rather than competitive
- In the case of Complementors, an increase in sales for them is likely to increase the sales of the local firm as well

- The value net framework also encourages managers to consider other forms of cooperative interactions and realise value is created jointly by all industry participants
- Often a firm works together with its suppliers to ensure a smooth, more efficient operation for both parties
- Even direct rivals may work cooperatively if they participate in industry trade associations or engage in job lobbying efforts

FIGURE 2.9 The Value Net



- Value net analysis can help managers discover the potential to improve the position through cooperative as well as competitive interactions

Industry Dynamic and the Forces Driving Industry Change

Core Concept:

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

- It is critical to understand the nature and intensity of competitive and cooperative forces as well as understanding that the intensity of these forces are fluid and subject to change
- Industry and competitive conditions change because forces are enticing or pressuring certain industry participants to alter their actions
- The most powerful of these change agents are called driving forces because they have the biggest influence in reshaping the industry landscape and altering competitive conditions

- Some forces originate in the outer ring of the company's microenvironment but most originate in the company's more immediate industry and competitive environment
- **Driving-Forces analysis has three steps:**
    1. Identifying what the driving forces are;
    2. Assessing whether the drivers of change are, acting to make the industry more or less attractive; and
    3. Determining what strategy changes are needed to prepare for the impact of the driving forces

Identifying the Forces Driving Industry Change:

- **Many developments can affect an industry powerfully enough to qualify as a driving force, some are unique and specific to a particular industry but most fall into one of the following categories:**
    4. Changes in the industry's long-term growth rate
    5. Increasing globalisation
    6. Emerging new internet capabilities and applications
    7. Shifts in who buys the products and how the products are used
    8. Technological change and manufacturing process innovation
    9. Product innovation
    10. Entry or Exit of major firms
    11. Diffusion of technical know-how across companies and countries
    12. Changes in cost and efficiency
    13. Reductions in uncertainty and business risk
    14. Regulatory influences and movement policy changes
    15. Changing social concerns, attitudes and lifestyles

- The most important part of a driving-force analysis is to determine if the collective impact of the driving forces will increase or decrease market demand, increase or decrease the intensity of competition and lead to lower or higher profitability
- While many driving forces of change may be at work in a given industry, no more than three or four are likely to be true driving forces powerful enough to qualify as the major determinants of why and how the industry is changing

Assessing the Impact of the Forces Driving Industry Change:

- The second step in driving forces analysis is to determine whether the prevailing change drivers, on the whole are acting to make the industry environment more or less attractive
- **Three Questions can be asked:**
    1. Are the driving forces, on balance acting to cause demand for the industry 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?
- Getting a handle on the collective impact of the driving forces requires looking at the likely effects of each factor separately since the driving forces may not all be pushing change in the same direction

Adjusting the Strategy to Prepare for the Impact of Driving Forces:

- The third step in the strategic analysis of industry dynamics is for managers to draw some conclusions about what strategy adjustments will be needed to deal with the impacts of driving forces
- Taking the right kinds of actions to prepare for the industry and competitive changes being wrought by driving forces first requires accurate diagnosis of the forces driving industry change and their impacts
- To the extent that managers are unclear about the drivers of change and their impacts, or if their views are off-base, the chances of making astute and timely strategy adjustments are slim
- So this analysis is not something to take lightly, it has practical value and is basic to the task of thinking strategically about where the industry is headed and how to prepare for the changes ahead

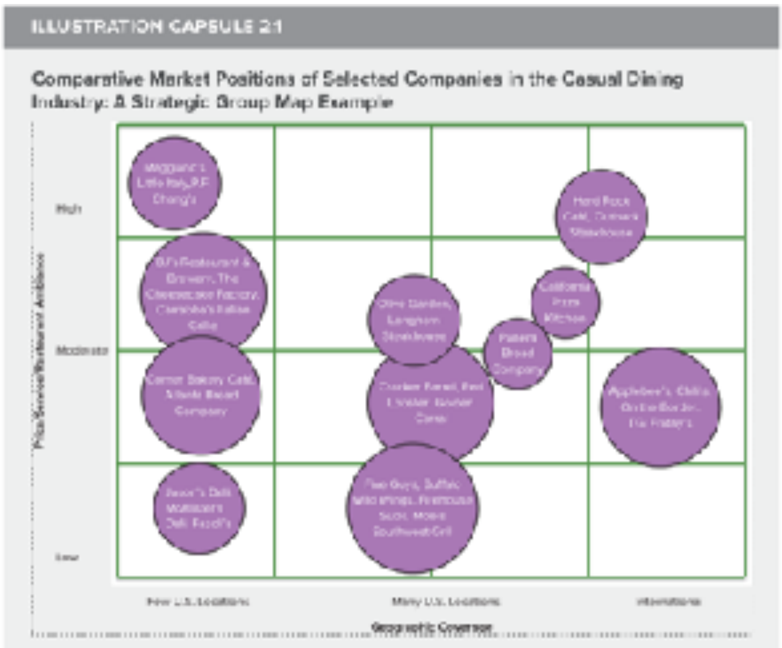
Strategic Group Analysis

- Within an industry companies commonly sell in different price or quality ranges, appeal to customers and so on
- Some are more attractively positioned than others

- The best technique for revealing the market positions of industry competitors is Strategic Group Mapping

Using Strategic Group Maps to Asses the Market Position of Key Competitors:

- A strategic group consists of industry members with similar competitive approaches and positions in the market
- Strategic group mapping is a technique for displaying the different market or competitive positions that rival firms occupy in the industry
- **The procedure for constructing a strategic group map is straightforward:**
  - Identify the competitive characteristics that delineate strategic approaches used in the industry
  - Plot the firms on a two-variable map using a pair of these variables
  - Assign firm 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 the total industry sales revenues



- **Typical Variables Used in Creating Group Maps:**
  - Price and Quality Range (high/low)
  - Geographic coverage (regional/local)
  - Product-line breadth (wide/narrow)
  - Degree of Service Offered (no frills/limited/full)
  - Degree of Vertical Integration (none/partial/full)
  - Degree of diversification into other Industries (none/some/considerable)

- **Guidelines for creating a Strategic Group Map:**
    - First, the two variables selected as axis for the map should not be highly correlated, if they are the circles could fall along a diagonal and reveal nothing about the relative positions
    - Second, the variable chosen as axes for the map should reflect important differences among rival approaches, when rivals differ on both variables the locations of rivals will be scattered, thus showing how they are positioned differently
    - Third, the variables used as axes don't have to be either quantitative or continuous, rather they can be discrete variables defined in terms of distinct classes and combinations
    - Fourth, drawing the size of the circles on the map proportional to the combined sales of the firms in the group allows the map to reflect the size of each strategic group
    - Fifth, if more than two good variables can be used as axes for the map then it is wise to draw several maps to give different exposures to the competitive positioning relationships presently in the industry's structure

The Value of Strategic Group Maps:

- Strategic group maps are revealing in several aspects
- The most important has to do with identifying which industry members are close rivals and which are distant rivals
- The second thing to be gleaned from strategic group mapping is that not all positions on the map are equally attractive
- **Two reasons account for why some positions can be more attractive than others;**
    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 favour some strategic groups and hurt others
- Some strategic groups are more favourably positioned than others because they confront weaker competitive forces and / or because they are more favourably impacted by industry driving forces

Competitor Analysis

- Gathering **Competitive Intelligence** about the strategic direction and likely moves of competitors allows a company to prepare a defensive countermove, craft its own strategies with confidence about what market manoeuvres to expect from rivals and to exploit openings that arise from competitors missteps
- Competitive Intelligence also involves gathering information about rivals to predict their next move
- **Signals of the likelihood of strategic moves:**
  - Rivals under pressure to improve financial performance
  - Rivals to increase market standing
  - Public statements of rivals intentions
  - Profiles developed by intelligence units

Porters Framework for Competitor Analysis:

- **Current Strategy:**
  - To success in predicting a competitors next moves, company strategists need to have a good understanding of the rivals current strategy, as an indication of its pattern of behaviour and best strategic options
  - Questions to ask: How is this competitor positioned in the market, What is the basis for its competitive advantage, What kinds of investments is it making ?
- **Objectives:**
  - An appraisal of a rivals objectives should not only include its financial performance objectives but strategic ones as well
  - It is also important to consider if the rivals are even meeting these objectives and whether it is under pressures to improve
  - Rivals meeting objectives are likely to keep it the same, poor performers are likely to change
- **Resources and Capabilities:**
  - A rivals strategic moves and countermoves are both enabled and constrained by the set of resources and capabilities the rival has
  - Thus a rivals resources and capabilities serve as a strong signal of future strategic actions

  - Assessing a rivals resources and capabilities involves sizing up not only its strengths but weaknesses as well
- **Assumptions:**
  - How a rivals top manages think about their strategic situation can have a big impact on how the rival behaves
  - Banks that believe they are too big to fail, may take on more risk than is financially prudent
  - Assessing a rivals assumptions entails considering its assumptions about itself as well as about the industry its in
- Accessing this information can often be found in press releases, information posted on websites and public documents like annual reports of 10-K fillings

Key Success Factors

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

- These factors are so important that all firms must pay attention to them or risk becoming an industry laggard or failure
- How well the elements of a company's strategy measure up against an industry's KSF determines whether that company meets the basic criteria and whether it will survive and thrive
- Identifying KSF's in the prevailing and anticipated industry and competitive conditions, is therefore a top priority in analytic and strategy making considerations
- Company strategists need to understand the industry landscape well enough to separate the factors most important to competitive success from those less important

- **KSF vary from industry to industry and even within the same industry as change drivers and competitive conditions change, three questions can however always be asked to identify them:**
    1. On what basis do buyers of the industry's product choose between the competing brands of sellers? What product attributes and characteristics are crucial?
    2. Given the nature of competitive rivalry prevailing in the marketplace, what resources and competitive capabilities must a company have to be completely successful?
    3. What shortcoming are almost certain to put a company at a significant competitive disadvantage?
- Only rarely are there more than five key factors for competitive success, and among those normally two or three outrank the others
- Managers should bear in mind why identifying key success factors is important, it is important to determine which factors are the most important to competitive success and to resist labelling a minor factor as a KSF

- In the beer industry, despite there being many types of buyers, it is important to understand the preferences and buying behaviour of customers
- Their purchase decisions are driven by price, taste and marketing
- Thus the KSF include a strong network of wholesale distribution and clever advertising
- Because there is potential for strong beer power on the part of large distributors and retail chains, competitive success depends on some mechanism to offset that power, of which advertising is one
- Thus the KSF's also include superior product differentiation or superior firms size and branding capabilities, as well as full utilisation of brewing capacity

- Correctly diagnosing an industry's KSF also raises the company's chances of crafting a new strategy
- The KSF of an industry point to those tings that every firm in the industry needs to attend to in order to retain customers and weather competition

- Where a company cannot deliver on the KSF's it is unlikely to earn profits and to remain a viable business

The Industry Outlook For Profitability

- Each of the frameworks in this block, PESTEL, the five forces, driving forces, strategy groups, competitor analysis and key success factors provide a useful perspective on an industry's outlook for profitability
- The final step in evaluating the industry and competitive environment is to use the results of each of the analyses of each and assess whether the industry has strong prospects for competitive success and atrlatcie profits
- **The important factors include:**
    1. How the company is being impacted by the state of the macro-environment;
    2. Whether strong competitive forces are squeezing industry profitability to subpar levels;
    3. Whether the presence of Complementors and the possibility of cooperative actions improve the company's prospects
    4. Whether industry profitability will be favourable or unfavourably affected by the prevailing driving forces
    5. Whether the company occupies a stronger market position than rivals;
    6. Whether this is likely to change in the course of competitive interactions
    7. How well the company's strategy delivers on the industry key success factors
- The anticipated industry environment is attractive if it presents a company with good opportunity for above-average profitability; the industry outlook is unattractive if a company's prospects are low
- However it is a mistake to think of a particular industry as being equally attractive or unattractive to all industry participants and potential entrants
- Attractiveness is relative, not absolute and conclusions have to be drawn from the perspective of a particular company
- For example; a favourably positioned competitor may see ample opportunity to capitalise on the vulnerabilities of weaker rivals even though industry conditions are otherwise unattractive

- Similarly, industries that are attractive to insiders may be unattractive to outsiders because of the difficulty of challenging current market leaders or because of more attractive opportunities elsewhere
- When a industry is attractive and presents good opportunities, a case should be made to invest aggressively in the business and improve long-term competitive position in that industry
- When a strong competitor decides an industry is unattractive it may decide to protect its position, investing cautiously and looking for opportunities elsewhere
- A competitively weak company in an unattractive industry may see the best option as finding a buyer to acquire its business