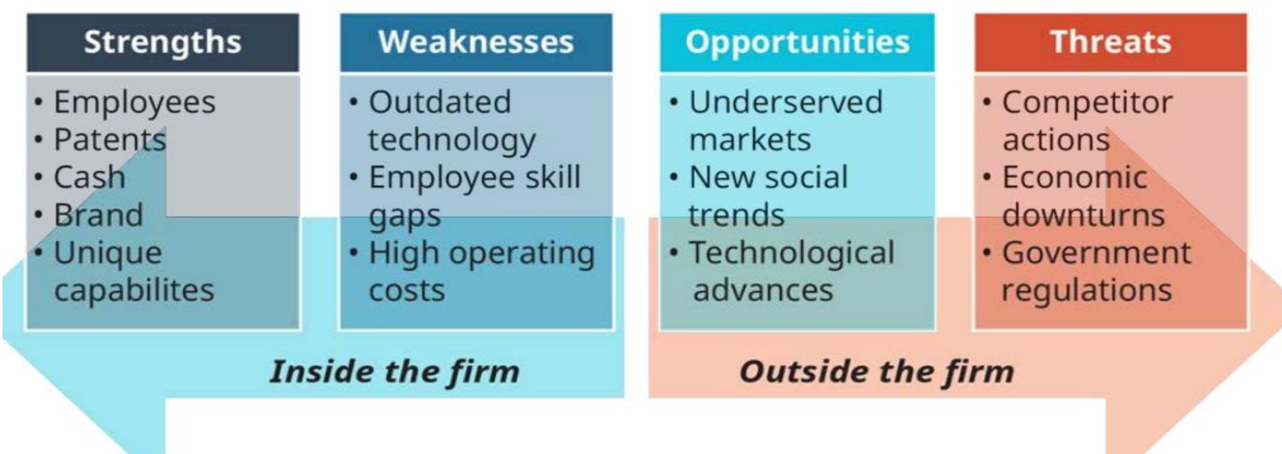
CHAPTER 8 POM NOTES

Strategic Analysis: Understanding a Firm's Competitive Environment

What is a SWOT analysis, and what can it reveal about a firm?

SWOT, which is an acronym for strengths, weaknesses, opportunities, and threats. Firms use SWOT analysis to get a general understanding of what they are good or bad at and what factors outside their doors might present chances for success or difficulty



Strengths A firm's strengths are, to put it simply, what it is good at.

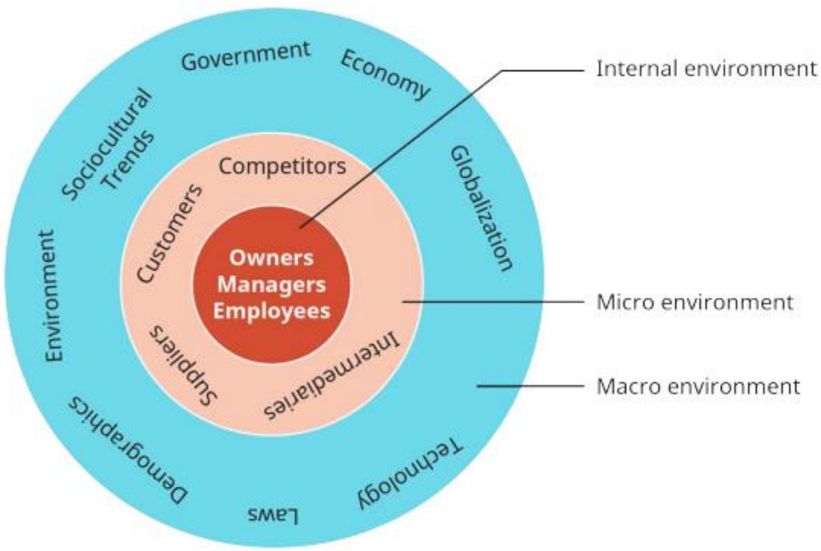
A firm's **weaknesses** are what it is not good at—things that it does not have the capabilities to perform well.

An **opportunity** is a potential situation that a firm is equipped to take advantage of.

When a manager assesses the external competitive environment, she labels anything that would make it harder for her firm to be successful as a **threat.**

A Firm's External Macro Environment: PESTEL

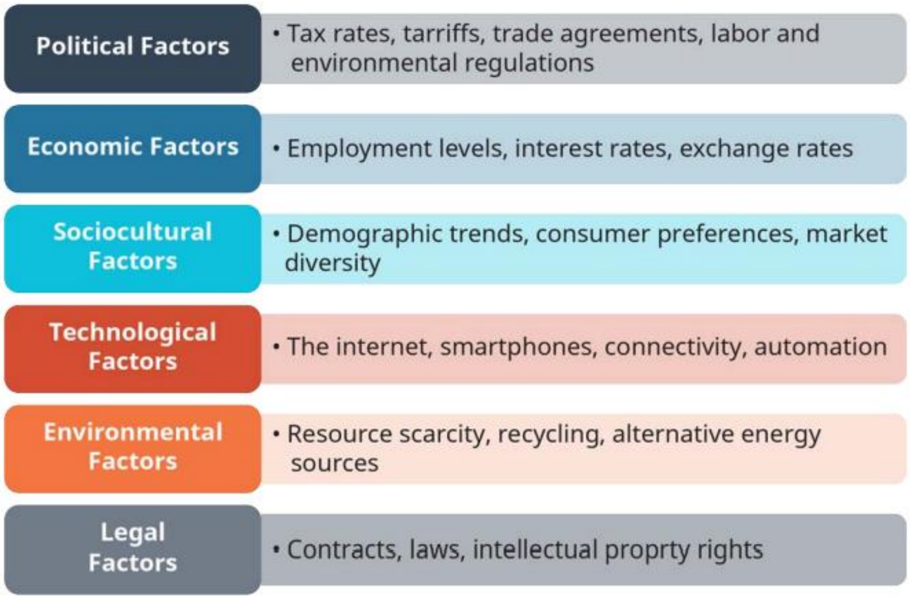
What makes up a firm's external macro environment, and what tools do strategists use to understand it?



A **firm's macro environment** contains elements that can impact the firm but are generally beyond its direct control. These elements are characteristics of the world at large and are factors that all businesses must contend with, regardless of the industry they are in or type of business they are.

PESTEL

PESTEL is a tool that reminds managers to look at several distinct categories in the macro environment. Like SWOT, PESTEL is an acronym. In this case, the letters represent the categories to examine: political factors, economic factors, sociocultural factors, technological factors, environmental factors, and legal factors.



Political factors in the macro environment include taxation, tariffs, trade agreements, labor regulations, and environmental regulations.

All firms are impacted by the state of the national and global economies. The increased interdependence of individual country economies has made evaluating the **economic factors** in a firm's macro environment more complex.

sociocultural factors PESTEL category that identifies trends, facts, and changes in society's composition, tastes, and behaviors, including demographics.

technological factors PESTEL category that includes factors such as the Internet, social media, automation, and other innovations that impact how businesses compete or how they manufacture, market, or sell their goods or services.

environmental factors PESTEL category that examines a firm's external situation with respect to the natural environment, including pollution, natural resource availability and preservation, and alternative energy.

legal factors In PESTEL, the laws impacting business, such as those governing contracts and intellectual property rights and illegal activities, such as online piracy.

A Firm's Micro Environment: Porter's Five Forces

Industry Rivalry

Industry rivalry, the first of Porter's forces, is in the center of the diagram. Note that the arrows in the diagram show two-way relationships between rivalry and all of the other forces. This is because each force can affect how hard firms in an industry must compete against each other to gain customers, establish favorable supplier relationships, and defend themselves against new firms entering the industry.

The Threat of New Entrants

In an industry, there are incumbent (existing) firms that compete against each other as rivals. If an industry has a growing market or is very profitable, however, it may attract new entrants. These either are firms that start up in the industry as new companies or are firms from another industry that expand their capabilities or target markets to compete in an industry that is new to them.

Threat of Substitutes

In the context of Porter's model, a substitute is any other product or service that can satisfy the same need for a customer as an industry's offerings. Be careful not to confuse substitutes with rivals. Rivals offer similar products or services and directly compete with one another.

Supplier Power

Virtually all firms have suppliers who sell parts, materials, labor, or products. Supplier power refers to the balance of power in the relationship between firms and their suppliers in an industry. Suppliers can have the upper hand in a relationship if they offer specialized products or control rare resources

Buyer Power

The last of Porter's forces is buyer power, which refers to the balance of power in the relationship between a firm and its customers. If a firm provides a unique good or service, it will have the power to charge its customers premium prices, because those customers have no choice but to buy from the firm if they need that product

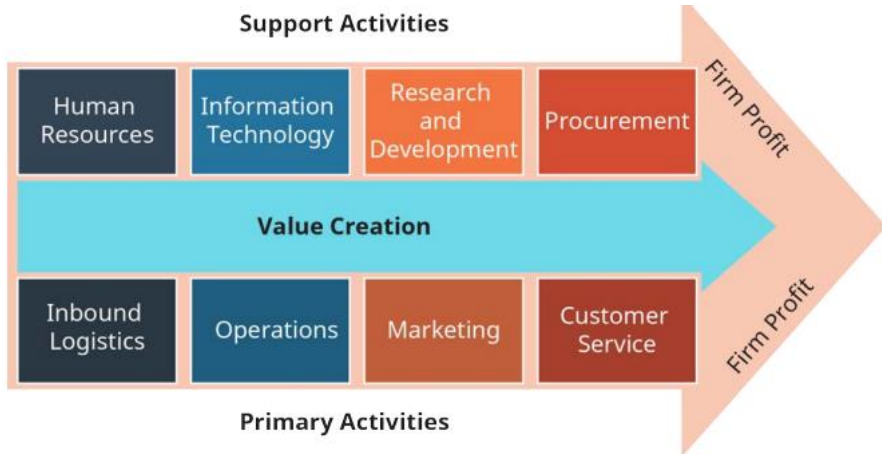
Resources and Capabilities

A firm's resources and capacities are the unique skills and assets it possesses. Resources are things a firm has to work with, such as equipment, facilities, raw materials, employees, and cash. Capabilities are things a firm can do, such as deliver good customer service or develop innovative products to create value. Both are the building blocks of a firm's plans and activities, and both are required if a firm is going to compete successfully against its rivals. Firms use their resources and leverage their capabilities to create products and services that have some advantage over competitors' products

The Value Chain

Before examining the role of resources and capabilities in firm success, let's take a look at the importance of how a firm uses those factors in its operations. A firm's value chain is the progression of activities it undertakes to create a product or service that consumers will pay for. A firm should be adding value at each of the chain of steps it follows to create its product. The goal is for the firm to add enough value so that its customers will believe that the product is worth buying for a price that is higher than the costs the firm incurs in making it.

hypothetical value chain for some of Walmart's activities.



In this example, note that value increases from left to right as Walmart performs more activities. If it adds enough value through its efforts, it will profit when it finally sells its services to customers. By working with product suppliers (procurement), getting those products to store locations efficiently (inbound logistics), and automatically keeping track of sales and inventory (information technology), Walmart is able to offer its customers a wide variety of products in one store at low prices, a service customers value.

Using VRIO

The analytical tool used to assess resources and capabilities is called VRIO. As usual, this is an acronym developed to remind managers of the questions to ask when evaluating their firms' resources and capabilities. The four questions of VRIO, which focus on value, rarity, imitation, and organization

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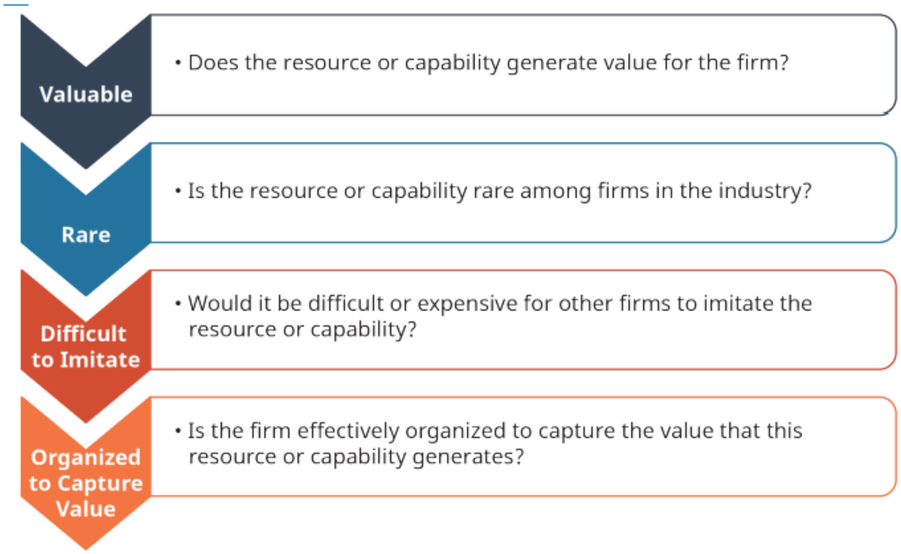

Key Terms

barriers to entry Industry factors (such as high start-up costs) that can prevent new firms from successfully launching new operations in that industry.

buyer power In the relationship between a firm and its customers, buyers with high power can negotiate product price or features, while buyers with low power cannot.

capabilities A firm's skill at coordinating and leveraging resources to create value.

competition Business actions a firm undertakes to attract customers to its products and away from competitors' products.

competitive advantage When a firm successfully attracts more customers, earns more profit, or returns more value to its shareholders than rival firms do.

competitive environment Factors and situations both inside the firm and outside the firm that have the potential to impact its operations and success.

cost-leadership strategy A generic business-level strategy in which a firm tightly controls costs throughout its value chain activities in order to offer customers low-priced goods and services at a profit.

demographics Part of PESTEL that includes facts about the income, education, age, and ethnic and racial composition of a population.

differentiation strategy A generic business-level strategy in which firms add value to their products and services in order to attract customers who are willing to pay a higher price.

economic factors PESTEL category that includes facts (such as unemployment rates, interest rates, and commodity prices) about the state of the local, national, or global economy.

environmental factors PESTEL category that examines a firm's external situation with respect to the natural environment, including pollution, natural resource availability and preservation, and alternative energy.

environmental scanning The systematic and intentional analysis of a firm's internal state and its external environment.

external environment The aspects of the world at large and of a firm's industry that can impact its operations.

external factors Things in the world or industry environments that may impact a firm's operations or success, such as the economy, government actions, or supplier power. Strategic decisions can be made in response to these things but normally cannot directly influence or change them.

focus strategy A generic business-level competitive strategy that firms use in combination with either a cost-leadership or differentiation strategy in order to target a smaller demographic or geographic market with specialized products or services.

generic business-level strategies Basic methods of organizing firm value chain activities to compete in a product market that can be used by any sized firm in any industry.

industry A group of firms all offering products or services in a single category, for example restaurants or athletic equipment.

industry rivalry One of Porter's Five Forces; refers to the intensity of competition between firms in an

internal environment Innermost layer of a firm’s competitive environment, including members of the firm itself (such as employees and managers), investors in the firm, and the resources and capabilities of a firm.

internal factors Characteristics of a firm itself, such as resources and capabilities, that the firm can use to successfully compete against its rivals.

legal factors In PESTEL, the laws impacting business, such as those governing contracts and intellectual

property rights and illegal activities, such as online piracy.

macro environment The outermost layer of elements in a firm’s external environment that can impact a business but are generally beyond the firm’s direct control, such as the economy and political activity.

micro environment The middle layer of elements in a firm’s external environment, primarily concerned with a firm’s industry situation.

new entrants One of Porter’s Five Forces, the threat of new entrants assesses the potential that a new firm will start operations in an industry.

opportunity A situation that a firm has the resources and capabilities to take advantage of.

PESTEL A strategic analysis tool that examines several distinct categories in the macro environment: **p**olitical, **e**conomic, **s**ociocultural, **t**echnological, **e**nvironmental, and **l**egal.

political factors PESTEL factor that identifies political activities in the macro environment that may be relevant to a firm’s operations.

Porter’s Five Forces Evaluates the interconnected relationships between various actors in an industry, including competing firms, their suppliers, and their customers, by examining five forces: industry rivalry, threat of new entrants, threat of substitutes, supplier power, and buyer power.

primary activities Firm activities on the value chain that are directly responsible for creating, selling, or servicing a product or service, such as manufacturing and marketing.

resources Things a firm has, such as cash and skilled employees, that it can use to create products or services.

sociocultural factors PESTEL category that identifies trends, facts, and changes in society’s composition, tastes, and behaviors, including demographics.

strategic analysis Process that firms use to study and understand their competitive environment.

strategic group Businesses offering similar products or services and following the same generic competitive strategy.

strategic positioning Firm's decisions on how to organize its actions and operate to effectively serve customers and compete against rivals.

strategy Process of planning and implementing actions that will lead to success in competition.

strengths Resources and capabilities of a firm; what it is good at.

substitutes One of Porter's Five Forces; products or services outside a firm's industry that can satisfy the same customer needs as industry products or services can.

supplier power One of Porter's Five Forces; describes the balance of power in the relationship between firms in an industry and their suppliers.

support activities Value chain activities that a firm performs to sustain itself; do not directly create a product or service but are necessary to support the firm's existence, such as accounting and human resources.

switching costs Penalty, financial or otherwise, that a consumer bears when giving up the use of a product currently being used to select a competing product or service.

SWOT Strategic analysis tool used to examine a firm's situation by looking at its **s**trengths, **w**eaknesses, **o**pportunities, and **t**hreats.

technological factors PESTEL category that includes factors such as the Internet, social media, automation, and other innovations that impact how businesses compete or how they manufacture, market, or sell their goods or services.

threat Anything in the competitive environment that would make it harder for a firm to be successful.

value chain Sequence of activities that firms perform to turn inputs (parts or supplies) into outputs (goods or services).

VRIO analytical tool that evaluates a firm's resources and capabilities to determine whether or not it can support an advantage for the firm in the competitive environment: **v**alue, **r**arity, **i**mitation, and **o**rganization.

weaknesses Things that a firm does not have good capabilities to perform or gaps in firm resources.

Summary of Learning Outcomes

8.1 Gaining Advantages by Understanding the Competitive Environment

1. What is strategic analysis, and why do firms need to analyze their competitive environment?

Strategic analysis is a systematic evaluation of a firm's situation, both internally and with respect to what is happening in the outside world. This analysis examines what the firm itself is good or bad at, how rivals in its industry are competing against it for customers, and what factors in the world environment, such as economic indicators or demographic changes, might impact the firm's ability to be successful. Firms need to conduct this analysis in order to be aware of and prepared for changes in their competitive environment and to maximize their chance of successfully competing against rivals and sustaining their profitability and market share in their industry.

8.2 Using SWOT for Strategic Analysis

2. What is a SWOT analysis, and what can it reveal about a firm?

SWOT is a traditional analytical tool that identifies a firm's strengths, weaknesses, opportunities, and threats (SWOT is an acronym of these four factors). It is useful for conducting a quick look at the internal capabilities (strengths and weaknesses) and external events and situations (opportunities and threats) a firm is facing. SWOT is not a comprehensive analytical tool, because the four categories for analysis are too broad and will not necessarily identify all of the factors important to a firm's success that a more thorough analysis would.

8.3 A Firm's External Macro Environment: PESTEL

3. What makes up a firm's external macro environment, and what tools do strategists use to understand it?

The external environment of a firm is composed of two primary layers: the macro environment and the micro environment. The macro environment includes facts and situations that a firm must be aware of but cannot always influence. The macro environment is analyzed using the PESTEL analytical tool that considers a firm's political and legal aspects, economic indicators, sociocultural trends, demographic facts, technological changes, and environmental aspects.

8.4 A Firm's Micro Environment: Porter's Five Forces

4. What makes up a firm’s external micro environment, and what tools do strategists use to understand it?

The second layer of a firm’s external environment is its micro environment, which includes the components of a firm’s industry, such as competitors, suppliers, and customers. Porter’s Five Forces of industry competition (industry rivalry, threat of new entrants, threat of substitutes, supplier power, and buyer power) capture the dynamic relationships between these components.

8.5 The Internal Environment

5. How and why do managers conduct an internal analysis of their firms?

Managers cannot lead their firms to success without understanding what the firm is able to do. An analysis of the firm’s resources and capabilities, as well as its gaps, is essential in determining the best path forward for the firm. A good strategy for competitive advantage capitalizes on a firm’s key resources and capabilities, as identified and evaluated using the VRIO (value, rarity, imitation, and organization) analytical tool. Resources and capabilities that satisfy VRIO criteria are the key things that a firm is best at, and these should be leveraged so the firm can compete against rivals.

8.6 Competition, Strategy, and Competitive Advantage

6. What does it mean to compete with other firms in a business environment, and what does it mean when a firm has a competitive advantage over its rivals and what generic strategies can a firm implement to gain advantage over its rivals?

Competition is the battle for customers. Firms compete against rivals offering similar products and services and try to attract customers by making sure their product or service is a little better or less expensive than those of their competitors. The firm that is most successful in this battle, measured in terms of profitability or in terms of market share, has a competitive advantage. Generic competitive strategies are the basic templates for organizing firm activities in order to achieve competitive advantage in an industry. A firm will perform value chain activities, such as marketing and research and development, in order to support the overall competitive strategy it has chosen. Following a generic cost-leadership strategy requires that a firm try to save money throughout the value chain so that it can offer customers low-priced goods and services. In contrast, differentiators add value to their products and services while performing value chain activities so that they can charge premium prices to consumers. A third generic competitive strategy, focus, is chosen in combination with one of the other two strategies by firms who decide to target smaller geographic or demographic customer groups.

8.7 Strategic Positioning

7. What elements go into determining a firm's strategic position?

A firm develops a strategic position in response to the factors present in its competitive environment. Strategic analysis is essential in identifying and understanding the factors that a strategic position must address. The choice of strategic position factors in a firm's key resources and capabilities when choosing a generic competitive strategy, product or service to be offered, target market, and geographic reach to compete successfully against rivals in an industry. To be successful in allowing a firm to achieve a competitive advantage in its industry, a firm's strategic position should be different from its competitors' positions in the same industry and should be hard for competitors to copy so that the firm's competitive advantage lasts.