

# **CHAPTER THREE**

## **THE EXTERNAL ENVIRONMENT**

# Chapter Objectives

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- 1. Describe how to conduct an external strategic-management audit.**
- 2. Discuss 10 major external forces that affect organizations: economic, social, cultural, demographic, environmental, political, governmental, legal, technological, and competitive.**
- 3. Describe key sources of external information, including the Internet.**
- 4. Discuss important forecasting tools used in strategic management.**
- 5. Discuss the importance of monitoring external trends and events.**
- 6. Explain how to develop an EFE Matrix.**
- 7. Explain how to develop a Competitive Profile Matrix.**
- 8. Discuss the importance of gathering competitive intelligence.**
- 9. Describe the trend toward cooperation among competitors.**
- 0. Discuss market commonality and resource similarity in relation to**

❖ “It is not the strongest species that survive, nor the most intelligent, but the one most responsive to change.” - *Charles Darwin*

❖ "The opportunities and threats existing in any situation always exceed the resources needed to exploit the opportunities or avoid the threats. Thus, strategy is essentially a problem of allocating resources. If strategy is to be successful, it must allocate superior resources against a decisive opportunity". — *William Cohen*

# The business environment

❖ The business environment can be grouped into two:

- External Environment
  - Remote/Macro/ General
  - Immediate/Micro/Task
- Internal environment

## Outcomes From *External* & *Internal* Environmental Analyses

**By Studying the External Environment, firms identify:**

- *What they might choose to do?*



**Examine opportunities & threats**

**By Studying the Internal Environment, firms identify:**

- *What they can do?*



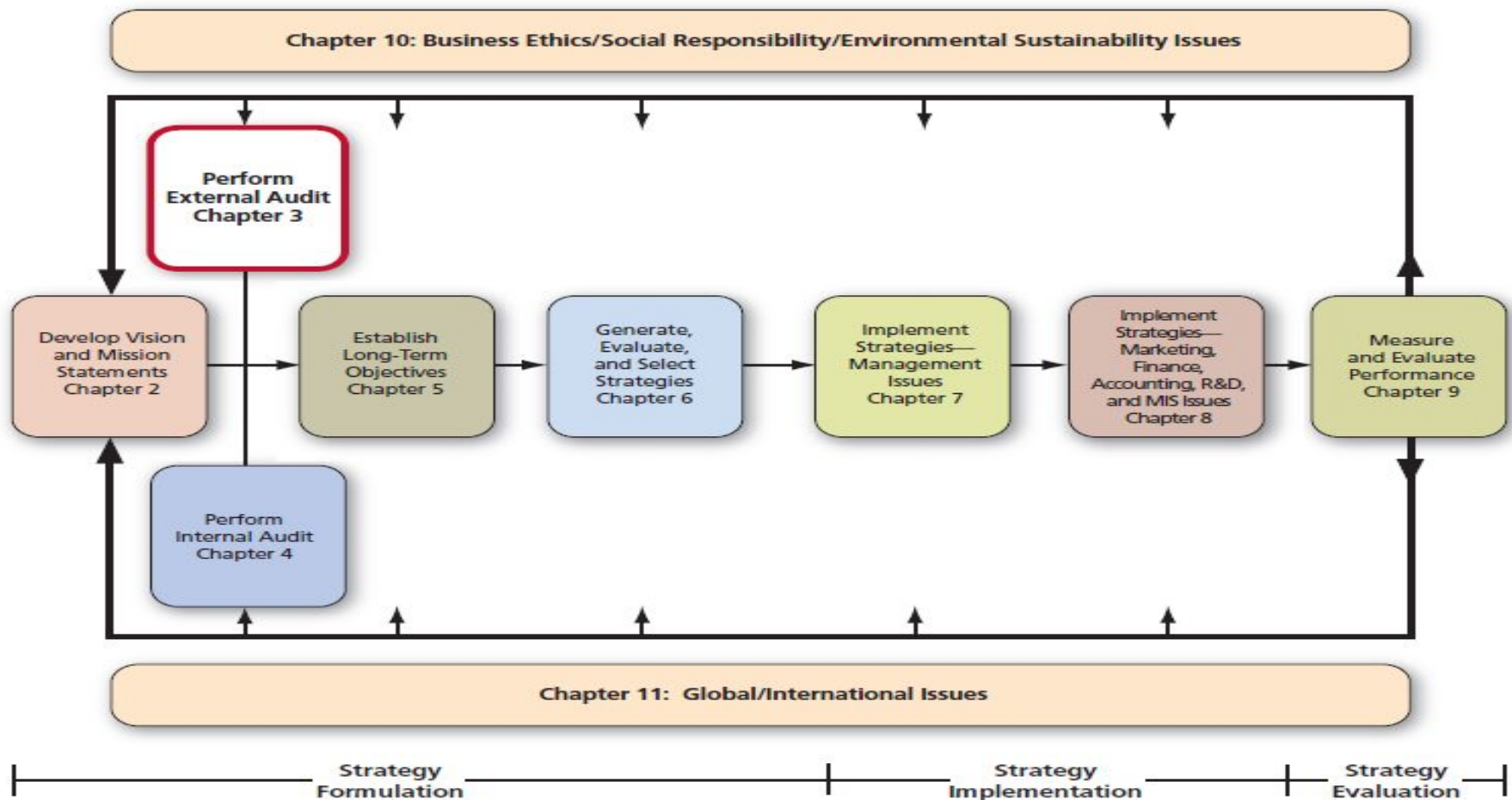
Examine unique resources,  
capabilities & competencies  
– sustainable competitive  
advantage



# A Comprehensive Strategic-Management Model

**FIGURE 3-1**

**A Comprehensive Strategic-Management Model**



# External env't .....

- focuses on identifying and evaluating trends and events beyond the control of a single firm
- reveals key **opportunities and threats** confronting an organization so that managers can formulate strategies to take advantage of the opportunities and avoid or reduce the impact of threats

# The Nature of an External Assessment

- ❖ The external Assessment is aimed at identifying **key variables** that offer actionable responses
- ❖ Firms should be able to respond either **offensively or defensively** to the factors by formulating strategies that take **advantage** of external opportunities or that **minimize** the impact of potential threats.



# External Analysis –steps

- ❖ **Step 1: Environmental scanning** – gather relevant information. It allows managers to stay up to date and reduce uncertainty
- ❖ **Step 2: Interpret environmental factors** – determine whether the factors are opportunities or threats. Identify the most important opportunities and threats
- ❖ **Step 3: Take actions to capitalize opportunities and minimize threats**

# External Analysis ...

## OPPORTUNITIES:

- ❖ An opportunity is a major favorable situation in a firm's environment.
- ❖ Identification of:
  - a previously overlooked market segment
  - changes in competitive or regulatory circumstances
  - technological changes, and
  - improved buyer or supplier relationships

# External analysis cont'd...

## THREATS:

- ❖ A threat is a major unfavorable situation in a firm's environment. Threats are key ingredients to the firm's current or desired position.
  
- ❖ Identification of
  - the entrance of new competitors
  - slow market growth
  - increased bargaining power of key buyers or suppliers,
  - technological changes, and new or revised regulations could represent threats to a firm's success.

# Why external analysis?

- ❖ External analysis allows firms to:
  - **Discover** threats and opportunities
  - **Make** informed decisions as best as possible
  - **Better** understand the nature of competition in an industry
  - **See** if above normal profits are likely in an industry

# Key External Forces

***External forces*** can be divided into five broad categories:

- 1.economic forces
- 2.social, cultural, demographic, and natural environment forces
- 3.political, governmental, and legal forces
- 4.technological forces
- 5.competitive forces

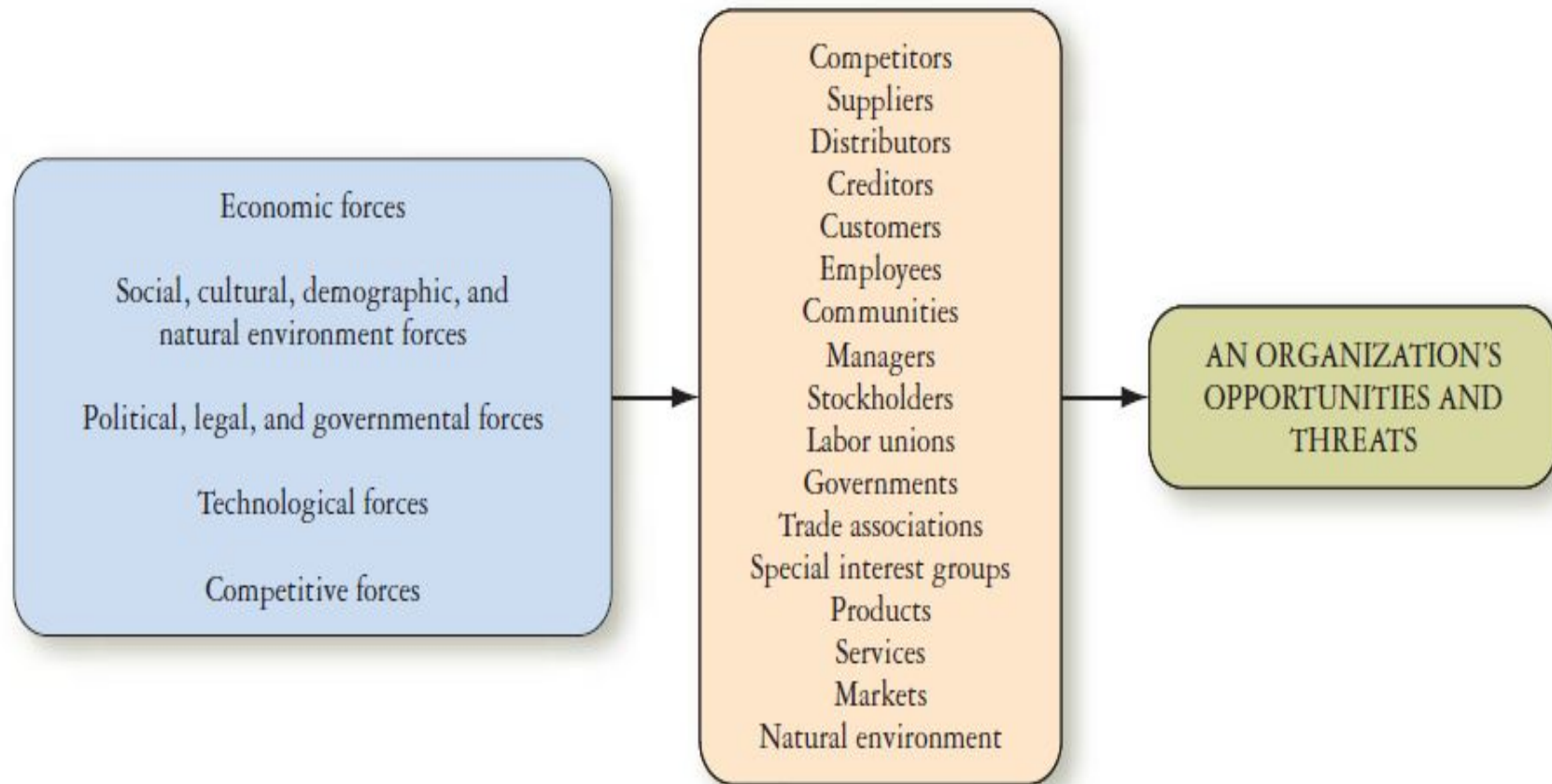
# Cont...

- ❖ External trends and events significantly affect goods, services, markets, and organizations worldwide.
- ❖ Changes in external forces translate into changes in consumer demand for both industrial and consumer products.
- ❖ External forces affect the types of products developed, the nature of positioning and market segmentation strategies, the type of services offered, and the choice of businesses to acquire or sell.
- ❖ Identifying and evaluating external opportunities and threats enables organizations to develop a clear mission, to design strategies to achieve long-term objectives, and

# Relationships Between Key External Forces and an Organization

**FIGURE 3-2**

## Relationships Between Key External Forces and an Organization



# The Process of Performing an External Audit

- ❖ First, gather **competitive intelligence** and information about economic, social, cultural, demographic, environmental, political, governmental, legal, and technological trends.
- ❖ Information should be assimilated and evaluated
- ❖ A final list of the most important key external factors should be communicated



# The Industrial Organization (I/O) View

- ❖ The *Industrial Organization (I/O)* approach to competitive advantage advocates that **external** (industry) factors are more important than **internal** factors in a firm for achieving competitive advantage.

# The Industrial Organization (I/O) View

❖ Firm performance  
is based more on  
industry properties

Economies of scale

Barriers to market entry

Product differentiation

The economy

Level of competitiveness

# Competitive Intelligence Programs



## **Competitive intelligence (CI)**

- a systematic and ethical process for gathering and analyzing information about the competition's activities and general business trends to further a business's own goals

# Competitive Intelligence Programs

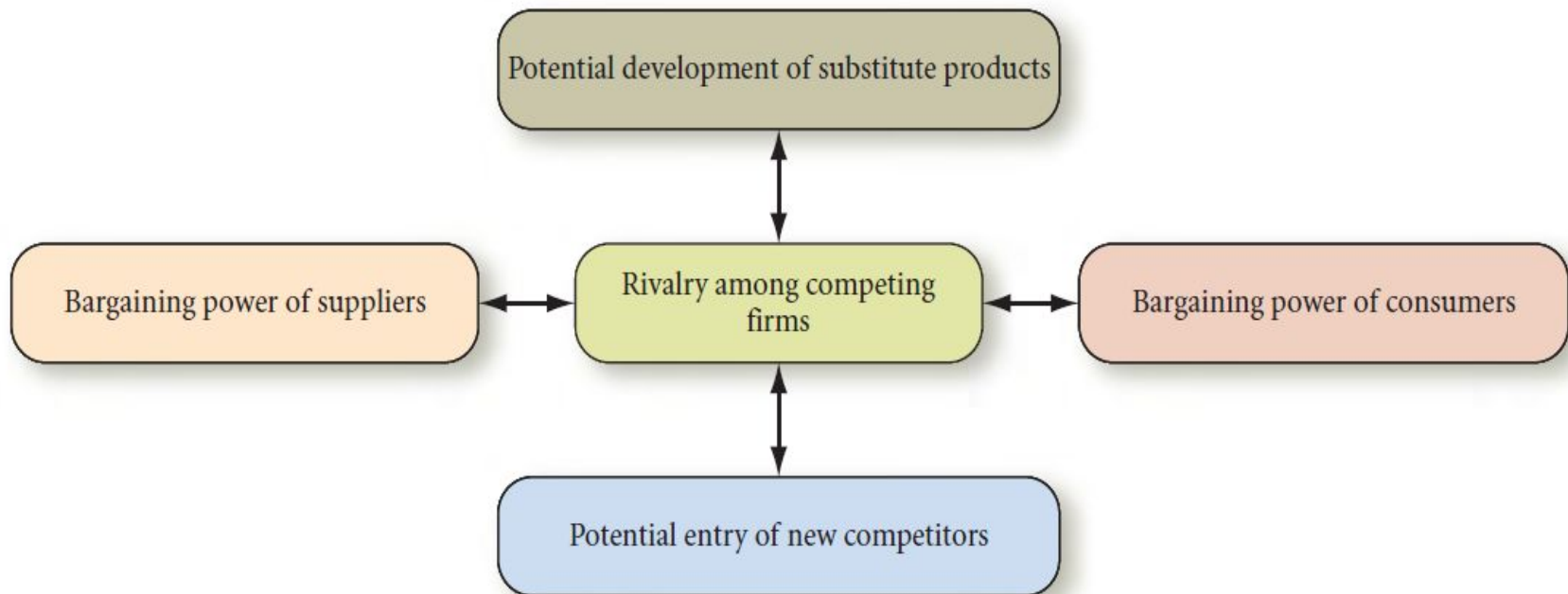
The three basic objectives of a CI program are:

1. to provide a general understanding of an industry and its competitors
2. to identify areas in which competitors are vulnerable and to assess the impact strategic actions would have on competitors
3. to identify potential moves that a competitor might make that would endanger a firm's position in the market

# The Five-Forces Model of Competition (PORTER'S FIVE-FORCE MODEL)

FIGURE 3-3

## The Five-Forces Model of Competition



# The Five-Forces Model of Competition

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1. Identify key aspects or elements of each competitive force that impact the firm.
2. Evaluate how strong and important each element is for the firm.
3. Decide whether the collective strength of the elements is worth the firm entering or staying in the industry.

# The Five-Forces Model



## **Rivalry among competing firms**

- Most powerful of the five forces
- Focus on competitive advantage of strategies over other firms

# The Five-Forces Model

**TABLE 3-9** Conditions That Cause High Rivalry Among Competing Firms

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1. High number of competing firms
  2. Similar size of firms competing
  3. Similar capability of firms competing
  4. Falling demand for the industry's products
  5. Falling product/service prices in the industry
  6. When consumers can switch brands easily
  7. When barriers to leaving the market are high
  8. When barriers to entering the market are low
  9. When fixed costs are high among firms competing
  10. When the product is perishable
  11. When rivals have excess capacity
  12. When consumer demand is falling
  13. When rivals have excess inventory
  14. When rivals sell similar products/services
  15. When mergers are common in the industry
-



# The Five-Forces Model

## ◆ **Potential Entry of New Competitors**

- Barriers to entry are important
- Quality, pricing, and marketing can overcome barriers

# Barriers to Entry

- ❖ Need to gain economies of scale quickly
- ❖ Need to gain technology and specialized know-how
- ❖ Lack of experience
- ❖ Strong customer loyalty
- ❖ Strong brand preferences
- ❖ Large capital requirements
- ❖ Lack of adequate distribution channels

# Barriers to Entry

- ❖ Government regulatory policies
- ❖ Tariffs
- ❖ Lack of access to raw materials
- ❖ Possession of patents
- ❖ Undesirable locations
- ❖ Counterattack by entrenched firms
- ❖ Potential saturation of the market

# The Five-Forces Model

## ◆ Potential development of substitute products

- Pressure increases when:
  - Prices of substitutes decrease
  - Consumers' switching costs decrease

# The Five-Forces Model

- ◆ **Bargaining Power of Suppliers** is increased when there are:
  - Large numbers of suppliers
  - Few substitutes
  - Costs of switching raw materials is high
- ◆ Backward integration is gaining control or ownership of suppliers

# The Five-Forces Model



## **Bargaining power of consumers**

- Customers being concentrated or buying in volume affects intensity of competition
- Consumer power is higher where products are standard or undifferentiated

# Conditions Where Consumers Gain Bargaining Power

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1. If buyers can inexpensively switch
2. If buyers are particularly important
3. If sellers are struggling in the face of falling consumer demand
4. If buyers are informed about sellers' products, prices, and costs
5. If buyers have discretion in whether and when they purchase the product

# Interpreting Industry Analysis

**Low entry barriers**

**Suppliers & buyers  
have strong positions**

**Strong threats from  
substitute products**

**Intense rivalry  
among competitors**

The diagram features a central green oval labeled "Unattractive industry". Four arrows point towards this oval from the left side. The arrows originate from the text blocks: "Low entry barriers", "Suppliers & buyers have strong positions", "Strong threats from substitute products", and "Intense rivalry among competitors".

**Unattractive  
industry**

**Low profit  
potential**



**High entry barriers**



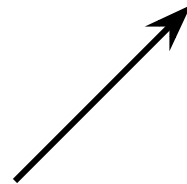
**Suppliers & buyers  
have weak positions**



**Few threats from  
substitute products**



**Moderate rivalry  
among competitors**



**Attractive  
industry**

**High profit  
potential**

# Industry Analysis: The External Factor Evaluation (EFE) Matrix

❖ Economic

❖ Social

❖ Cultural

❖ Demographic

❖ Environmental

❖ Political

❖ Governmental

❖ Technological

❖ Competitive

❖ Legal

# The External Factor Evaluation (EFE) Matrix Steps

1. List key external factors
2. Weight from 0 to 1
3. Rate effectiveness of current strategies
4. Multiply weight \* rating
5. Sum weighted scores

# EFE Matrix for a Local Ten-Theater Cinema Complex

**TABLE 3-10** EFE Matrix for a Local Ten-Theater Cinema Complex

Key External Factors	Weight	Rating	Weighted Score
Opportunities			
1. Rowan County is growing 8% annually in population	0.05	3	0.15
2. TDB University is expanding 6% annually	0.08	4	0.32
3. Major competitor across town recently ceased operations	0.08	3	0.24
4. Demand for going to cinema growing 10% annually	0.07	2	0.14
5. Two new neighborhoods being developed within 3 miles	0.09	1	0.09
6. Disposable income among citizens grew 5% in prior year	0.06	3	0.18
7. Unemployment rate in county declined to 3.1%	0.03	2	0.06
Threats			
8. Trend toward healthy eating eroding concession sales	0.12	4	0.48
9. Demand for online movies and DVDs growing 10% annually	0.06	2	0.12
10. Commercial property adjacent to cinemas for sale	0.06	3	0.18
11. TDB University installing an on-campus movie theater	0.04	3	0.12
12. County and city property taxes increasing 25% this year	0.08	2	0.16
13. Local religious groups object to R-rated movies being shown	0.04	3	0.12
14. Movies rented from local Blockbuster store up 12%	0.08	2	0.16
15. Movies rented last quarter from Time Warner up 15%	0.06	1	0.06
<b>Total</b>	<b>1.00</b>		<b>2.58</b>

# Industry Analysis: Competitive Profile Matrix (CPM)

- ❖ Identifies firm's major competitors and their **strengths** & **weaknesses** in relation to a sample firm's strategic positions
- ❖ Critical **success factors** include internal and external issues

# An Example Competitive Profile Matrix

**TABLE 3-12** An Example Competitive Profile Matrix

Critical Success Factors	Company 1			Company 2		Company 3	
	Weight	Rating	Score	Rating	Score	Rating	Score
Advertising	0.20	1	0.20	4	0.80	3	0.60
Product Quality	0.10	4	0.40	3	0.30	2	0.20
Price Competitiveness	0.10	3	0.30	2	0.20	1	0.10
Management	0.10	4	0.40	3	0.20	1	0.10
Financial Position	0.15	4	0.60	2	0.30	3	0.45
Customer Loyalty	0.10	4	0.40	3	0.30	2	0.20
Global Expansion	0.20	4	0.80	1	0.20	2	0.40
Market Share	<u>0.05</u>	1	<u>0.05</u>	4	<u>0.20</u>	3	<u>0.15</u>
<b>Total</b>	<b>1.00</b>		<b>3.15</b>		<b>2.50</b>		<b>2.20</b>

*Note:* (1) The ratings values are as follows: 1 = major weakness, 2 = minor weakness, 3 = minor strength, 4 = major strength. (2) As indicated by the total weighted score of 2.50, Competitor 2 is weakest. (3) Only eight critical success factors are included for simplicity; this is too few in actuality.