**Chapter 3 Lecture Note**

**Evaluating a Company’s External Environment**

Chapter Summary

Chapter Three explores the concepts and analytical tools for assessing strategically important factors in a company’s external environment. Attention centers on tools for determining the level of competition, mapping market positions of key rivals, and evaluating the long term outlook for growth and profitability.

Lecture Outline

**I. Introduction**

1.Chapter 2 identified that the strategy-formulation strategy-execution process begins with an appraisal of the company’s present situation. The company’s situation includes two facets: (1) the competitive conditions in the industry in which the company operates—its external environment; and (2) its resources and organizational capabilities—its internal environment.

2. This chapter presents the concepts and analytical tools for zeroing in on a single-business company’s external environment.

**II. Evaluating the Strategically Relevant Components of a Company’s Macro-Environment**

1. Strictly speaking, a company’s macro-environment includes *all relevant factors and influences* outside the company’s boundaries; by relevant, we mean these factors are important enough that they should shape management’s decisions regarding the company’s long-term direction, objectives and business model.

CORE CONCEPT

The **macro-environment** encompasses the broad environmental context in which a company is situated and is comprised of six principal components: political factors, economic conditions, sociocultural forces, technological factors, environmental factors, and legal/regulatory conditions.

**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 forces.

1. **Figure 3.1 The Components of a Company’s External Environment**, presents a depiction of macro-environmental factors with a high potential to affect a company’s business situation.
2. The factors and forces in a company’s macro-environment that have the *biggest* strategy shaping impact typically pertain to the company’s immediate industry and competitive environment – competitive pressures, the actions of rival firms, buyer behavior and supplier related considerations .

**III. Assessing the Company’s Industry and Competitive Environment**

1. Thinking strategically about a company’s industry and competitive environment entails using some well-validated concepts and analytical tools to get clear answers to seven questions:

a. Do the dominant economic characteristics of the industry offer sellers opportunities for growth and attractive profits?

b. What kinds of competitive forces are industry members facing, and how strong is each force?

c. What forces are driving industry change, and what impact will these changes have on competitive intensity and industry profitability?

d. What market positions do industry rivals occupy—who is strongly positioned and who is not?

e. What strategic moves are rivals likely to make next?

f. What are the key factors of competitive success?

g. Does the industry outlook offer good prospects for profitability?

2. **Table 3.1, The Six Components of the Macro-Environment Included in a PESTEL Analysis**, describes the external factors that shape the company’s macro-environment.

**IV. Question 1: What are the Industry’s Dominant Economic Features?**

1. Because industries differ so significantly, analyzing a company’s industry and competitive environment begins with identifying the industry’s dominant economic features and forming a picture of the industry landscape.

2. An industry’s dominant economic features are defined by such factors as;

* market size and growth rate,
* scope of competitive rivalry
* demand supply conditions
* market segmentation
* pace of technological change

3. **Table 3.2, What to Consider in Identifying an Industry’s Dominant Economic Features**,provides a summary of analytical questions that define the industry’s dominant economic features.

4. Getting a handle on an industry’s distinguishing economic features not only provides a broad overview of the attractiveness of the industry, but also promotes understanding of the kinds of strategic moves that industry members are likely to employ.

**V. Question 2: How Strong Are the Industry’s Competitive Forces?**

1. The nature and subtleties of the competitive forces operating in a company’s industry are never the same from one industry to another and must be wholly understood to accurately form answers to the question, “*Where are we now?”*

2. The most powerful and widely used tool for assessing the strength of the industry’s competitive forces is the *five-forces model of competition*.

3. **Figure 3.2, The Five-Forces Model of Competition** holds that competitive forces affecting industry attractiveness go beyond rivalry of competing sellers and include pressures stemming from four co-existing forces:

a. Competitive pressures stemming from buyer bargaining power.

b. Competitive pressures coming from companies in other industries to win buyers over to substitute products.

c. Competitive pressures stemming from supplier bargaining power.

d. Competitive pressures associated with the threat of new entrants into the market.

e. Competitive pressures associated with rivalry among competing sellers to attract customers. This is usually the strongest of the five competitive forces.

A. **Competitive Force of Buyer Bargaining Power**

1. Whether seller-buyer relationships represent a weak or strong competitive force depends on:

a. Whether some or many of the buyers have sufficient bargaining leverage to obtain price concessions and other favorable terms and conditions of sale.

b. The extent and competitive importance of seller-buyer strategic partnerships in the industry.

2. **Factors affecting buyer bargaining power can create competitive pressures:** The leverage that certain types of buyers have in negotiating favorable terms can range from weak to strong.

3. Even if buyers do not purchase in large quantities or offer a seller important market exposure or prestige, they gain a degree of bargaining leverage in the following circumstances:

a. If buyers’ costs of switching to competing brands or substitutes are relatively low – buyers who can readily switch brands or source from several sellers have more negotiating leverage than buyers who have high switching costs.

b. If the number of buyers is small or if a customer is particularly important to a seller – the smaller the number of buyers, the less easy it is for sellers to find alternative buyers when a customer is lost to a competitor.

c. If buyer demand is weak – weak or declining demand creates a “buyers market” and shifts bargaining power to buyers .

d. If buyers are well-informed about sellers’ products, prices, and costs – the more information buyers have, the better bargaining position they are in.

e. If buyers pose a credible threat of integrating backward into the business of sellers – companies like Anheuser-Busch, Coors, and Heinz have integrated backward into metal-can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerful metal-can manufacturers.

4. Not all buyers of an industry’s product have equal degrees of bargaining power with sellers and some may be less sensitive than others to price, quality, or service differences.

5. **Figure 3.3, Factors Affecting the Strength of the Bargaining Power of Buyers**, summarizes the circumstances that make for strong or weak bargaining power on the part of buyers.

**B. The Competitive Force of Substitute Products**

1. Companies in one industry are vulnerable to competitive pressure from the actions of companies in another industry whenever buyers view the products of the two industries as a good substitute.

2. Just how strong the competitive pressures are from sellers of substitute products depends on three factors:

a. Whether substitutes are readily available and attractively priced.

b. Whether buyers view the substitutes as being comparable or better in terms of quality, performance, and other relevant attributes.

c. Whether the costs that buyers incur in switching to the substitutes are high or low.

3. **Figure 3.4, Factors Affecting Competition from Substitute Products**, lists factors affecting the strength of competitive pressures from substitute products and signs that indicate substitutes are a strong competitive force.

4. As a rule, the lower the price of substitutes, the higher their quality and performance, and the lower the user’s switching costs, the more intense the competitive pressures posed by substitute products.

**C. Competitive Force of Supplier Bargaining Power**

1. Whether supplier-seller relationships represent a weak or strong competitive force depends on the degree to which suppliers have sufficient bargaining power to influence the terms and conditions of supply in their favor.

2. **How Supplier Bargaining Power Can Create Competitive Pressures:** When the major suppliers to an industry have considerable leverage in determining the terms and conditions of the item they are supplying, they are in a position to exert competitive pressures on one or more rival sellers.

3. The factors that determine whether any of the suppliers to an industry are in a position to exert substantial bargaining power or leverage are fairly clear-cut:

a. If the item being supplied is a commodity that is readily available from many suppliers,

b. The ability of industry members to switch their purchases from one supplier to another or to switch to attractive substitutes,

c. If certain inputs are in short supply,

d. If certain suppliers provide a differentiated input that enhances the performance, quality, or image of the industry’s product,

e. Whether certain suppliers provide equipment or services that deliver cost-savings to industry members in conducting their operations,

f. The fraction of costs of the industry’s product accounted for by the cost of a particular input

g f industry members are major customers of suppliers

h. Whether it makes good economic sense for industry members to vertically integrate backward.

4. **Figure 3.5, Factors Affecting the Strength of Suppliers Bargaining Power**, summarizes the conditions that tend to make supplier bargaining power strong or weak.

**D. Competitive Force of Potential New Entrants**

1.Several factors affect the strength of the competitive threats of potential entry in a particular industry.

2. One factor relates to the size of the pool of likely entry candidates and the resources at their command. As a rule, competitive pressures intensify as the pool of entry candidates increases in size.

3. Frequently, the strongest competitive pressures associated with potential entry come not from outsiders but from current industry participants looking for growth opportunities.

4. Existing industry members are often strong candidates to enter market segments or geographic areas where they currently do not have a market presence.

5. A second factor concerns whether the likely entry candidates face high or low entry barriers. The most widely encountered barriers that entry candidates must hurdle include:

a. The presence of sizable economies of scale in production or other areas of operation – When incumbent companies enjoy cost advantages associated with large-scale operation, outsiders must either enter on a large scale or accept a cost disadvantage and consequently lower profitability.

b. Cost and resource disadvantages not related to scale of operation – Aside from economies of scale, industry incumbents can have cost advantages that stem from experience/learning curve effects, the possession of proprietary technology, partnerships with the best and cheapest suppliers, and low fixed costs.

c. Strong brand preferences and high degree of customer loyalty – In some industries, buyers are strongly attached to established brands, making it more difficult for a newcomer to break into the marketplace.

d. High capital requirements – The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants.

e. The difficulties of building a network of distributors or retailers and securing adequate space on retailers’ shelves.

f. Restrictive regulatory policies – Government agencies can limit or even bar entry by requiring licenses and patents.

g. Tariffs and international trade restrictions – National governments commonly use tariffs and trade restrictions to raise entry barriers for foreign firms and protect domestic producers from outside competition.

h. The ability and willingness of industry incumbents to launch vigorous initiatives to block a newcomer’s successful entry.

6. **Figure 3.6, Factors Affecting the Strength of Threat of Entry,** identifies several factors that affect how strong the competitive threat of potential entry is in a particular industry.

**E. The Competitive Force of Rivalry among Competing Sellers**

1.The strongest of the five competitive forces is nearly always the rivalry among competing sellers – the marketing maneuvering and jockeying for buyer patronage that continually go on.

2. In effect, a market is a competitive battlefield where it is customary and expected that rival sellers will employ whatever resources and weapons they have in their business arsenal to improve their market positions and performance.

3. **Figure 3.7, Factors Affecting the Strength of Rivalry,** shows a sampling of competitive weapons that firms can deploy in battling rivals and indicates the factors that influence the intensity of their rivalry.

4. Some of the factors that influence the tempo of rivalry among industry competitors include:

a. Rivalry intensifies when competing sellers are active in launching fresh actions to boost their market standing and business performance.

b. Rivalry is stronger in industries where competitors are equal in size and capability.

c. Rivalry is usually stronger in slow-growing markets and weaker in fast-growing markets.

d. Rivalry is usually weaker in industries comprised of so many rivals that the impact of any one company’s actions is spread thinly across all industry members. Likewise, it is often weak when there are fewer than five competitors.

e. Rivalry increases when buyer demand falls off and sellers find themselves with excess capability and/or inventory.

f. Rivalry increases as it becomes less costly for buyers to switch brands.

g. Rivalry increases as the products of rival sellers become more standardized.

h. Rivalry is more intense when industry conditions tempt competitors to use price cuts or other competitive weapons to boost unit volumes.

i. Rivalry increases when one or more competitors become dissatisfied with their market position.

j. Rivalry increases when strong companies outside acquire weak firms inside the industry and launch aggressive, well-funded moves to transform their newly acquired competitors into major market contenders.

5. Rivalry can be characterized as cutthroat or brutal when competitors engage in protracted price wars or habitually employ other aggressive tactics that are mutually destructive to profitability.

**F. The Collective Strengths of the Five Competitive and Industry Profitability**

1. Scrutinizing each competitive force one by one provides a powerful diagnosis of what competition is like in a given market.

2. As a rule, the stronger the collective impact of the five competitive forces, the lower the combined profitability of industry participants.

3. The most extreme case of a “competitively unattractive” industry is when all five forces are producing strong competitive pressures.

4. In contrast, when the collective impact of the five competitive forces is moderate to weak, an industry is competitively attractive in the sense that industry members can reasonably expect to earn good profits and a nice returns on investment.

5. The ideal competitive environment for earning superior profits is one in which both suppliers and customers are in weak bargaining positions, there are no good substitutes, high barriers block further entry, and rivalry among present sellers generates only moderate competitive pressures.

**VI. Question 3: What Are the Industry’s Driving Forces of Change and What Impact Will They Have?**

1. The intensity of competitive forces and the level of industry attractiveness are almost always fluid and subject to change.

**A. The Concept of Driving Forces**

1. Driving-forces analysis has three steps:

a. Identifying what the driving forces are,

b. Assessing whether the drivers of change are, individually or collectively, acting to make the industry more or less attractive, and

c. Determining what strategy changes are needed to prepare for the impact of the driving forces.

CORE CONCEPT

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

**B. Identifying an Industry’s Dominant Driving Forces**

1. Many developments can affect an industry powerfully enough to qualify as driving forces. Some are unique and specific to a particular industry situation, but most drivers of change fall into one of the following categories:

a. Changes in an industry’s long-term growth

b. Increasing globalization

c. Changes in who buys the product and how they use it

d. Product innovation

e. Technological change and manufacturing process innovation

f. Marketing innovation

g. Entry or exit of major firms

h. Diffusion of technical know-how across more companies and more countries

i. Changes in cost and efficiency

j. Growing buyer preferences for differentiated products

k. Regulatory influences and government policy changes

l. Changing societal concerns, attitudes, and lifestyles

2. **Table 3.3, Common Driving Forces**, summarizes the most common forces.

3. Company strategists must resist the temptation to label every change they see as a driving force.

**C. Assessing the Impact of the Driving Forces**

1. The second step of driving forces analysis is to determine whether the prevailing driving forces are acting to make the industry environment more or less attractive.

**D. Determining Strategy Changes Needed to Prepare for the Impact of the Driving Forces**

1. The third step of driving forces analysis is for managers to draw some conclusions about what strategy adjustments will be needed to deal with the impact of the driving forces.

2. An important part of driving forces analysis is to determine whether the individual or 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.

3. 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.

**VII. Question 4: How are Industry Rivals Positioned?**

1. The best technique for revealing the market positions of industry competitors is **strategic group mapping**. This analytical tool is useful for comparing the market positions of industry competitors or for grouping industry combatants into like positions.

CORE CONCEPT

**Strategic group mapping** is a technique for displaying the different market or competitive positions that rival firms occupy in the industry.

**A. Using Strategic Group Maps to Assess the Market Positions of Key Competitors**

1. A strategic group consists of those industry members with similar competitive approaches and positions in the market.

CORE CONCEPT

A **strategic group** is a cluster of industry rivals that have similar competitive approaches and market positions.

2. The procedure for constructing a strategic group map is straightforward:

a. Identify the competitive characteristics that differentiate firms in the industry

b. Plot the firms on a two-variable map using pairs of these differentiating characteristics

c. Assign firms that fall in about the same strategy space to the same strategic group

d. Draw circles around each strategic group, making the circles proportional to the size of the group’s respective share of total industry sales revenue

3. This procedure is illustrated in Concepts & Connections 3.1, Comparative Market Positions of Selected Retail Chains.

**B. The Value of Strategic Group Maps**

1. Strategic Group maps are revealing in several respects.

a. The most important has to do with identifying which rivals are similarly positioned and are thus close rivals and which are distant rivals. Generally speaking, the closer strategic groups are to each other on the map, the stronger the cross-group competitive rivalry tends to be.

b. Not all positions on the map are equally attractive. Two reasons account for why some positions can be more attractive than others; 1) Industry driving forces may favor some strategic groups and hurt others and 2) Competitive pressures may cause the profit potential of different strategic groups to vary.

**VIII. Question 5: What Strategic Moves Are Rivals Likely to Make Next?**

1. Having good information to predict the likely moves of key competitors allows a company to prepare defensive countermoves and to exploit any openings that arise from competitors mishaps.

2. Predicting the Moves of Industry Rivals:

a. What executives are saying about where the industry is headed, the firm’s situation, and their past actions and leadership styles.

b. Identifying trends in the timing of new product launches or marketing promotions.

1. Determining which rivals badly need to increase their unit sales and market share.

d. Considering which rivals have a strong incentive, along with resources, to make major strategic changes.

e. Knowing which rivals are likely to enter new geographic markets.

f. Deciding which rivals are strong candidates to expand their product offerings and enter new product segments.

3. Those who gather competitive intelligence on rivals can sometimes cross the fine line between honest inquiry and unethical or even illegal behavior. This is illustrated in **Concepts & Connectiosn 3.2, Business Ethics and Competitive Intelligence.**

**IX. Question 6: What are the Key Factors for Future Competitive Success?**

1. An industry’s **key success factors (KSF)** are those competitive factors that most affect industry members’ ability to prosper in the marketplace.

CORE CONCEPT

**Key success factors** are the strategy elements, product attributes, competitive capabilities, or intangible assets with the greatest impact on future competitive success in the marketplace.

2. An industry’s key success factors can usually be deduced through identifying the industry’s dominant characteristics, assessing the five competitive forces, comparing the market positions of industry members, and forecasting the likely next moves of key rivals.

3. **Table 3.4, Common Types of Industry Key Success Factors (KSFs)**, lists the common types of KSFs.

4. The answer to three questions helps identify an industry’s key success factors:

a. On what basis do buyers of the industry’s product choose between the competing brands of sellers? That is, what product attributes are crucial?

b. Given the nature of the competitive forces prevailing in the marketplace, what resources and competitive capabilities does a company need to have to be competitively successful?

c. What shortcomings are almost certain to put a company at a significant competitive disadvantage?

5. Only rarely are there more than five or six key factors for future competitive success.

**X. Question 7: Does the Industry Offer Good Prospects for Attractive Profits?**

1. The final step in evaluating the industry and competitive environment is boiling down the results in Questions 1-6 to determine if the industry offers a company strong prospects for attractive profits.

2. The important factors on which to base such a conclusion include:

a. The industry’s growth potential

b. Whether powerful competitive forces are squeezing industry profitability to subpar levels and whether competition appears destined to grow stronger or weaker

c. Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces

d. The company’s competitive position in the industry vis-à-vis

e. How competently the company performs industry key success factors.

3. As a general proposition, if an industry’s overall profit prospects are above average, the industry environment is basically attractive; if industry profit prospects are below average, conditions are unattractive.