Chapter Four

External Environment Analysis

An external Audit focuses on identifying and evaluating trends and events beyond the control of a single firm, such as increased foreign competition, population shifts to the Sunbelt, an aging society, information technology, and the computer revolution.

4.1 The nature of external audit

The purpose of an external audit is to develop a finite list of opportunities that could benefit a firm and threats that should be avoided. The external audit is not aimed at developing an exhaustive list of every possible factor that could influence the business. Rather it 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.

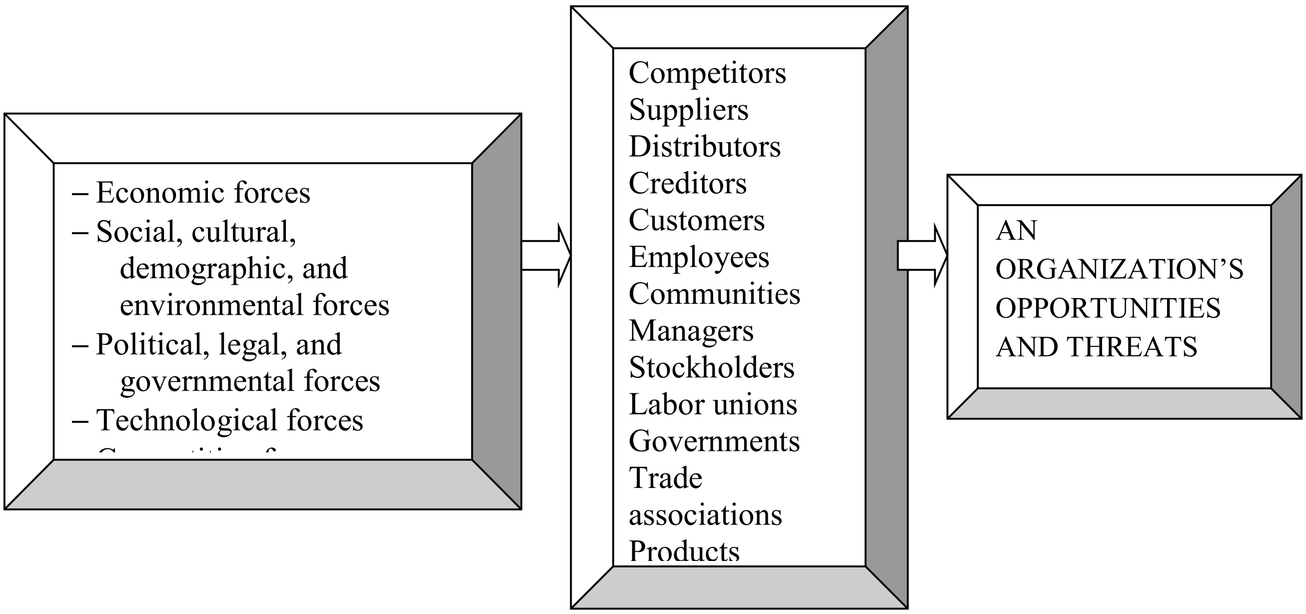
Key external forces

External forces can be divided in to five broad categories: (1) economic forces; (2) social, cultural, demographic, and environmental forces; (3) political, governmental, and legal forces; (4) technological forces; and (5) competitive forces. Relationships among these forces and an organization are depicted in the following figure.

Changes in external forces translate in to changes in consumer demand for both industrial and consumer products and services. External forces affect the types of products developed, the nature of positioning and market segmentation strategies, the types of services offered, and the choice of businesses to acquire or sell. External forces directly affect both suppliers and distributors. Identifying and evaluating external opportunities and threats enable organizations to develop a clear mission, to design strategies to achieve long-term objectives, and to develop policies to achieve annual objectives.

Figure 4-1

Relationships between key external forces and an organization



The process of performing an external audit:

The process of performing an external audit must involve as many managers and employees as possible.

To perform an external audit, a company must first gather competitive intelligence and information about social, cultural, demographic, environmental, economic, political, legal, governmental, and technological trends. Individuals can be asked to monitor various sources of information such as key magazines, trade journals, and news papers. Suppliers, distributors, salespersons, customers, and competitors represent other sources of vital information.

Once information is gathered it should be assimilated and evaluated. Key success factors should be listed on flipcharts or a blackboard. Key success factors can vary over time and industry. Other variables commonly used include market share, breadth of competing products, world economies, foreign affiliates, proprietary and key account advantages, technological advancements, population shifts, interest rates, and pollution abatement. An industry's **key success factors (KSFs)** are those competitive factors that most affect industry members' ability to prosper in the marketplace—the particular strategy elements, product attributes, resources, competencies, competitive capabilities, and market achievements that spell the difference between being a strong competitor and a weak competitor and sometimes between profit and loss. KSFs by their very nature are so important to future competitive success that *all firms* in the industry must pay close attention to them or risk becoming an industry also ran. To indicate the significance of KSFs another way, how well a company's product offering resources, and capabilities measure up against an industry's KSFs determines just how financially and competitively successful that company will be.

Key success factors should be

1. *Important to achieving long-term and annual objectives,*
2. *Measurable,*
3. *Relatively few in number,*
4. *Applicable to all competing firms, and*
5. *Hierarchical in the sense that some will pertain to the overall company and others will be more narrowly focused on functional or divisional areas.*

ECONOMIC FORCES

Economic factors have a direct impact on the potential attractiveness of various strategies. A summary of economic variables that often represent opportunities and threats for organizations is provided in the following table. Trends in dollar value have significant and unequal effects on companies in different industries and in different locations.

Availability of credit Level of disposable income Propensity of people to spend Interest rates Inflation rates Economies of scale Money market shares Government budget deficits GDP trend Consumption patterns Unemployment trends Worker productivity levels	Stock market trends Value of dollar in world market trends Stock market trends Foreign countries' economic conditions Import/export factors Demand shifts Income differences by region and consumer groups Price fluctuations Monetary policies Fiscal policies Tax rates

SOCIAL, CULTURAL, DEMOGRAPHIC, AND ENVIRONMENTAL FORCES

Social, cultural, demographic, and environmental changes have a major impact upon virtually all products, services, markets, and customers. Small, large, for-profit and nonprofit organizations in all industries are being staggered and challenges by the opportunities and threats arising from changes in social, cultural, demographic, and environmental variables. New trends are creating different types of consumers and, consequently, a need for different products, different services, and different strategies.

Number of marriages, divorces, births, and deaths Life expectancy rates Per-capita income Attitude towards business Lifestyles Attitude toward work Buying habits Ethical concerns Attitude toward saving Sex roles Attitude towards retirement, leisure time, product quality, and customer service	Pollution control Population changes by race, age, sex, and level of affluence Population changes by city, county, state, region and country Changes in tastes and preferences Number of women and minority workers Number of graduates Waste management Air pollution Water pollution

POLITICAL, GOVERNMENTAL, AND LEGAL FORCES

Federal, state, local, and foreign governments are major regulators, subsidizers, employers, and customers of organizations. Political, governmental, and legal factors can therefore represent key opportunities or threats for both small and large organizations. For industries and firms that depend heavily on government contracts or subsidies, political forecasts can be the most important part of an external audit. Changes in patent laws, antitrust legislation, tax rates, and lobbying activities can affect firms significantly.

The increasing global interdependence among economies, markets, governments, and organizations makes it imperative that firms consider the possible impact of political variables on the formulation and implementation of competitive strategies. A number of nationally known firms forecast political, governmental, and legal variables. Political forecasting can be especially critical and complex for multinational firms that depend on foreign countries for natural resources, facilities, distribution of products, special assistance, or customers. Strategists today must possess skills to deal more legalistically and politically than previous strategists, whose attention was directed more to economic and technical affairs of the firm. Strategists today are spending more time anticipating and influencing public policy actions. Before entering or expanding international operations, strategists need a good understanding of the political and decision making process in countries where their firm may conduct business.

Government regulations or deregulations Changes in tax laws Special tariffs Political action Number, severity, and location of government protests Number of patents Changes in patent laws	Environmental protection laws Legislation on equal employment Level of government subsidies Import export legislation Political conditions in foreign countries Size of government budget Government fiscal, and monetary policy changes

Local, state, and federal laws, regulatory agencies, and special interest groups can have a major impact on the strategies of small, large, for-profit, and nonprofit organizations. Many companies have altered have altered or abandoned strategies in the past because of political or governmental actions.

TECHNOLOGICAL FORCES

Revolutionary technological changes and discoveries such as superconductivity, computer engineering, robotics, unmanned factories, space communications, fiber optics, biometrics, and electronic funds transfer are having a dramatic impact on organizations. Technological forces represent major opportunities and threats that must be considered in formulating strategies. Technological advancement can dramatically affect organizations' products, services, markets, suppliers, distributors, competitors, customers, manufacturing processes, marketing practices, and competitive position.

Technological advancements can create new markets, result in a proliferation of new and improved products, change the relative competitive cost position in an industry, and render existing products obsolete. Technological changes can reduce or eliminate cost barriers between businesses, create shorter production runs, create shortages in technical skills, and result in changing values and expectation of employees, managers, and customers. Technological advancements can create new competitive advantages that are more powerful than existing advantages. An emerging consensus holds that technology management is one of the key responsibilities of strategists. Firms should pursue strategies that take advantage of technological opportunities to achieve sustainable, competitive advantages in the market place.

Technology-based issues will underlie nearly every important decision that strategists make. Crucial to those decisions will be the availability to approach technology planning analytically and strategically….technology can be planned and managed using formal techniques similar to built on a penetrating analysis of technology opportunities and threats, and an assessment of the relative importance of these factors to overall corporate strategy.

In practice, critical decisions about technology are too often delegated to lower organizational levels or are made without understanding of their strategic implications. The impact of this oversight is devastating. Firms not managing technology to ensure their futures may eventually find their future managed by technology. Although some industries may appear to be relatively technology insensitive in terms of products and market requirements, they are not immune from the impact of technology. For strategists in industries affected by rapid technological change, identifying and evaluating technological opportunities and threats can represent the most important part of an external audit.

Key questions to ask in assessing the technological environment

What are the technologies within the corporation?	What are the applications of the firm's technologies?
Which technologies are utilized in the firm's business?	What should be the priorities of technological resource investment?
How critical is each technology to each of these products and businesses?	What should be the level and rate of corporate technology investment?
Which technologies are contained in purchased parts and materials?	Which technological investments should be curtailed?
What was the evolution of these technologies overtime?	What additional technologies will be required to achieve the current business objectives?
What were the investment patterns of its leading technological competitors?	What are the implications of the technology and business portfolio for corporate strategy?

4.2 Sources of external information

A wealth of strategic information is available to organizations from both published and unpublished sources. Unpublished sources include customer surveys, market research, speeches in meetings, television programs, interviews, and conversation with stakeholders. Published sources include periodicals, journals, reports, government documents, abstracts, books, directories, newspapers, and manuals.

Indexes: a number of excellent indexes reveal the location of strategic information by subject, topic, source, author, company, and industry. Indexes can save managers considerable time and effort in identifying and evaluating opportunities and threats.

Online databases: millions of people today use online services for both business and personal purpose. There are various companies which provide commercial online services.

Library publications: it includes various published sources of strategic information.

4.3 Forecasting tools and techniques

Forecasts are educated assumptions about future trends and events. Managers often must rely upon published forecasts to identify key external opportunities and threats effectively. When published forecasts of key external or internal variables are not available, organizations must develop their own projections. Forecasting tools can be broadly categorized into two groups: quantitative techniques and qualitative techniques. Quantitative forecasts are most appropriate when historical data are available and when the relationships among key variables are expected to remain the same in the future. The three basic types of quantitative forecasting techniques are *econometric models, regression*, and *trend extrapolation*. All quantitative forecast, regardless of statistical sophistication and complexity, are based on historical relationships among variables.

The six basic qualitative approaches to forecasting are

1) *Sales force estimate,*
2) *Juries of executive opinion,*

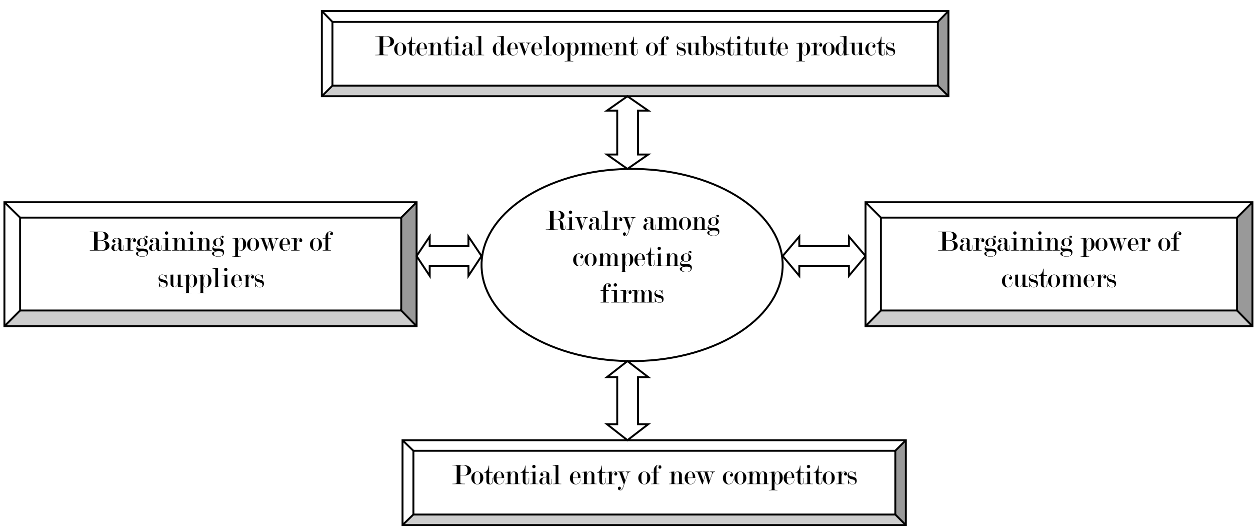
3) *Anticipatory surveys or market research,*
4) *Scenario forecasts,*
5) *Delphi forecasts, and*
6) *Brainstorming*

Qualitative or judgmental forecasts are particularly useful when historical data are not available or when constituent variables are expected to change significantly in the future. By identifying future occurrences that could have a major effect on the firm and making reasonable assumption about those factors, strategists can carry the strategic-management process forward.

4.4 Competitive analysis: Porter's five forces model

Porter's *five-force model* of competitive analysis is a widely used approach for developing strategies in many industries. The intensity of competition among firms varies widely across industries. According to porter, the nature of competitiveness in a given industry can be viewed as a composite of five forces:

1. *Rivalry among competitive forces*
2. *Potential entry of new competitors*
3. *Potential; development of substitute products*
4. *Bargaining power of suppliers*
5. *Bargaining power*



RIVALRY AMONG COMPETING FIRMS:

Rivalry among competing firms is usually the most powerful of the five competitive forces. The strategies pursued by one firm can be successful only to the extent that they provide competitive advantage over the strategies being pursued by rival firms. Changes in strategy by one firm may be met with retaliatory countermoves, such as lowering price, enhancing quality, adding features, providing services, extending warranties, and increasing advertising. The intensity of rivalry among competing firms tends to increase

- ✓ As the number of competitors increases,
- ✓ As competitors become more equal in size and capability,
- ✓ As demand for the industry's products decline, and
- ✓ As price cutting becomes common.

Rivalry also increases when consumers can switch brands easily, when barriers to leaving the market are high, when fixed costs are high, when the product is perishable, when rival firms are diverse in strategies, origins, and culture, and when mergers and acquisitions are common in the industry. As rivalry among competing firms intensifies, industry profits decline, in some cases to the point where an industry becomes inherently unattractive.

POTENTIAL ENTRY OF NEW COMPETITORS:

Whenever new firms can easily enter a particular industry, the intensity of competitiveness among firms increases. Barriers to entry, however, can include the need to gain economies of scale quickly, the need to gain technology and specialized knowhow, the lack of experience, strong customer loyalty, strong brand preferences, large capital requirements, lack of adequate distribution channels, government regulatory policies, tariffs, lack of access to raw materials, possession patents, undesirable locations, counterattack by entrenched firms, and potential saturation of the market. Despite numerous barriers to entry, new firms sometime enter industries with higher quality products, lower prices, and substantial marketing resources. *The strategist's job is, therefore, to identify potential new firms entering the market, to monitor the new firms' strategies, to counter attack as needed, and to capitalize on existing strengths and opportunities.*

DEVELOPMENT OF SUBSTITUTE PRODUCTS:

In many industries, firms are in close competition with producers of substitute products in other industries e.g. Plastic container producers competing with glass producers. The presence of substitute products puts a ceiling on the price that can be charged before the consumers will switch to the substitute product.

Competitive pressures arising from substitute products increase as the relative price of substitute products declines and as consumers' switching costs decrease. The competitive strength of substitute products is best measured by the inroads in to market share, as well as those firms' plans for increased capacity and market penetration.

BARGAINING POWER OF SUPPLIERS:

The bargaining power of suppliers affects the intensity of competition in an industry, especially when there is a large number of suppliers, when there are only a few good substitute raw materials, or when the cost of switching raw material is especially costly. It is often in the best interest of both suppliers and producers to assist each other with reasonable prices, improved quality, development of newer services, just-in-time deliveries, and reduced inventory costs, thus enhancing long-term profitability for all concerned. Firms may pursue a backward integration strategy to gain control or ownership of suppliers. The strategy is especially effective when suppliers are unreliable, too costly, or not capable of meeting the firm's needs on a consistent basis. Firms can generally negotiate more favorable term switch suppliers when backward integration is a commonly used strategy among rival firms in an industry.

BARGAINIG POWER OF CONSUMERS:

When customers are concentrated, large, or buy in volume, their bargaining power represents a major forces affecting intensity of competition in an industry. Rival firms may offer extended warranties or special services to gain customer loyalty whenever the bargaining power of consumer is substantial. Bargaining power of consumers is also higher when the products being purchased are standard or undifferentiated. When this is the case, consumers can often negotiate selling price, warranty coverage, and necessary packages to a greater extent.