Module 2

External Context of Strategic Decisions

Introduction

Organisations' sustainability and profitability is contingent upon the opportunities and threats created by the external environment. The environment is too vague and large, therefore the organisations need to restrict their analysis to those areas from the SEPT factors from the macro environment that impact it the most, followed by the analysis of the industry's structure and the strategic groups within it (this is called the TOE analysis in the module). Having delineated the factors to be studied, the organisations organise the systemic analysis in terms of the methodology and the responsibility within managerial cadres.

Upon completion of this module you will be able to:

Outcomes

- *define* threat, opportunity, and environment analysis.
- *describe* the factors in the external environment.
- *distinguish* between strategic groups, industry and sector.
- *explain* the role of the five factors in industry analysis.
- *conduct* an industry analysis using five forces framework.
- *demonstrate* the ability to conduct TOE analysis for a chosen company.

Terminology

Bargaining power:	A dominant position from where better returns from the other party can be negotiated.
Competition:	Indicates the number of organisations competing for similar resources or buyers.
Demography:	Study of population in terms of age profiles groupings etc.
Strategic groups:	Groups of organisations competing in a similar manner in an industry.
TOE analysis:	Analysis of the external environment; acronym derived from threat opportunity environment analysis.

External environment, threat and opportunity analysis

You are aware of the impact of the external environment on the organisation from the previous module. The external environment is dynamic, complex and diverse. There is no one set of factors that create conditions conducive or hostile to business. It is the interactive dynamics of different factors that does so. Let us consider a few products that were once essential parts of daily life but are nowhere to be seen today. The horse-drawn carriage was once the means of transport of the wealthy in almost every part of the world. The motor car was developed: it was sturdier, cleaner, easier to use, faster and fitted better with the lifestyle changes that mechanisation brought about and thus the motor car gradually replaced the horse carriage. The improved economic conditions of people as they shifted from agriculture to employment with industry or government helped the masses to purchase a car suited to their budget. The motor car itself has undergone many changes in the engine, design, shape, fuel consumption, and features, in the last 60 years. Today, there are cars that run on fuels other than petrol, have better safety, navigation, aesthetics and transmission features than their predecessors. The kerosene lantern was the mode of lighting and the wood stove the mode of cooking and heating about 70 years ago. They too were displaced by devices that were easier to use and manage.

The profitability of an organisation depends on its ability to offer products/services that are more competitive in terms of price, quality, and durability, ease of use, availability, contemporary, or combination of these. To take decisions for long-term profitability and sustainability an organisation has to be aware of changing customer expectations, emerging technologies, changing markets and realities, and expectations of performance, new systems of regulation and control of business and many other factors. Undoubtedly the external environment is dynamic, complex and diverse, creating discontinuities that are deemed to be threatening by most organisations, but the environment also presents more opportunities. The opportunities to access newer markets, cost-effective technologies and create diverse products within the same genre are exponentially more than 50 years ago. It has also meant there are now more organisations demanding a share of the wealth pie.

Opportunities or threats are relative to the extent and degree of preparedness of the organisation through its internal resource configuration, process design, structure and the depth of its management capability. These are the organisation's strengths. There may be opportunities but if the organisation lacks resources, design/process or ability to leverage any of these then the organisation has an inherent weaknesses that makes it vulnerable. Whether the organisation is prepared to make the best of what the environment has to offer depends on its strengths or weaknesses. The SWOT analysis is carried out in tandem and is a popular tool for analysinghyj business situations. Module 2 discusses the opportunities and the threats, whereas Module 3 discusses the strengths and weaknesses, that is, the internal context.

Activity 2.1

Activity

Profiling key changes

Objective: This activity is designed to give you an insight in the rates and reach of some of those changes that have impacted the way humans live and conduct themselves. This prepares you to appreciate the inevitability and pervasiveness of change better.

Electricity was discovered in the 1800s, followed by the invention of television in 1925. Computers in 1944 and the Ethernet in 1973, the ICT technologies in 1990 and the iPad in 2000. In this period other changes that have been significant include railways, air transportation, fixed line telephony, mobile telephony. Map on a time line those changes among these you feel are most significant. Study the time gap between one significant change and the other and answer the following questions:

1. Is the time gap between path-breaking innovations/ discoveries increasing or decreasing?
2. Is the number of people affected by the change increasing or decreasing?
3. List the names of at least three dominant organisations associated with the changes you have listed.

All the factors are not critical for an organisation to study. It has to focus attention on a select few factors that make an impact on it in the long term.

On the basis of the opinion of the key managers, past experience and industry consultations, managers decide which trends, events or expectations to consider in the conduct of ETO analysis.

Trends tend to be indicative of a forthcoming change that will have a mass clamour or demand. For example, car manufacturers see a trend of awareness and concern for the depletion of fossil fuels, increasing awareness about the harmful effects of emission of greenhouse gases, and the desirability of going green with fuel among consumers. This awareness is setting the trend for cars that run on alternative sustainable fuels and are what is euphemistically called “green cars”. The trend is at present incipient but will catch up in Asian countries almost as soon as it does in the developed world. This is a trend that car makers like Tata and Hyundai in Asia would be concerned about. If alternative fuel is cheaper than fossil fuel, or mandated by government (large intra-city transport buses in India’s capital city New Delhi by mandate have to use Compressed Natural Gas, CNG, as fuel) customers will either prefer it or be compelled to buy it.

Events are more specific to an organisation than trends. Events, whether positive or negative, have a bearing on an organisation’s image, prospects and industry prospects. The oil spill of Exxon Valdez was an adverse event for the oil company Exxon. It had implications on the risk management for high sea exploration for all organisations in the industry.

The poisoning of vials of Tylenol an over-the-counter medication of the pharmaceutical company Johnson &Johnson was also an event that impacted the reputation and customer confidence adversely not only for the company, but led to greater cautiousness about introducing tamper-proof packaging in the entire industry.

Expectations from business have been changing. Earlier, business was expected to be a vehicle to generate prosperity. Not any longer. In different countries business is now expected to be more proactive to meet the societal expectations which can be for better governance or for greater responsiveness to preserving the ecological environment, or participating in providing better basic amenities or developing a system for inclusive growth. Expectations beyond business-related performance are now global. The expectation constituency could be local. Social responsibility is now expected to be an integral part of strategy rather than a stand-alone action. Addressing these expectations would need large scale configuration of resources. Post-economic meltdown, there is much scepticism about the inequitable distribution of wealth and the quality of corporate governance. An expectation for better governance and transparent working should affect the decisions pertaining to composition of the board, valuation, and profit distribution disclosures.

Managers need a framework to analyse the environment. They need to understand those factors that are more relevant to their business from the myriad of external factors. (A perusal of the trends, expectations and events helps to find the starting point.) They need knowledge about the tools and techniques that can be used for environmental analysis and an understanding of coping with the challenges the environment presents.

Awareness about the nature, scope, direction, and impact of changes that are taking place external to the organisation is brought by the study and analysis of the external environment. The process of analysing and interpreting the environment is called external appraisal/analysis or environment threat and opportunity (TOE-analysis). The outcomes of the TOE analysis are then used as inputs to strategic decision making.

For TOE analysis the environment is studied at the level of:

- **The macro**, general or the strategic environment consisting of the Social, Economic, Politico-legal, Technology factors acronym as **SEPT** factors, alternatively another acronym used is the **PEST factors.** These four variables are insufficient to capture the relevant factors and, depending on its focus, the organisation may also choose to study institutional factors, globalisation and ecological and social concerns.
- **Industry**. The industry profitability determines the organisation’s strategy. The determinants of the profitability – the five forces espoused by Michael Porter are studied here.
- **The industry life cycle** stage of the organisation.
- **The strategic grouping** within the industry. The strategic grouping determines if the organisation can move at all within the given industry.

Macro environment appraisal

Macro environment encapsulates diverse factors which can interact to create new businesses, technologies and markets or destroy industries. Before we take up the detailed study of the external environment, let us consider two examples for understanding the diverse, complex and dynamic nature of the environment.

The Internet is an example of dynamic diffusion within the external environment. The Internet developed in military and academic institutions, has gradually become the tool for doing business efficiently and impacting the organisation's profitability as well as people's lives. Google, Facebook, Yahoo, and Amazon are multibillion dollar businesses based on the Internet. Technology is not the only factor that has a cascade effect on other industries. Consider the case of an increasing number of women joining the educated work force. As their numbers swell, businesses that meet their hitherto unknown or unexpressed demands metamorphose into large organisations and industries. So one observes the growth of domestic appliances industry and a segment within the travel and tourism industry dedicated to women. They have the purchasing power to consume these products. The following sections discuss the major forces of the external environment following the sequence in acronym SEPT.

Economic factors

Overall economic factors impact the availability and cost of capital, input costs, and expensiveness of its exports, valuation of the currency and the areas available for expansion or diversification of business. These are the direct or indirect drivers of profitability.

The economic factor includes the GDP growth of the country, the economic contribution of different sectors such as agriculture, manufacturing and services in an economy, the attractiveness of its export and investment.

Some of the key economic factors that impact the organisation's choice are:

- *The economic cycle:* The economic cycle affects the overall business climate. When the overall economy of a country is in a recession organisations cut expenditure including that on research and development. Wage freezes and layoff reduce the availability of money in the economy tightening the situation further. Organisations may put off strategic investments in such a situation.

- *Interest rates:* Interest rates affect the supply side and make products or services cheaper/expensive thereby affecting the competitiveness. Most of the time the exchange rates are determined by central banks. A case in point is the housing loan market in any large country. The lower interest rates attract more buyers. Interest rates also determine demand for cars and gadgets. In emerging markets an interesting area to observe is the higher education loan segment.

- *Currency exchange rates:* have a direct effect on the competitiveness of an organisation's exports. The rising cost of the rupee against the U.S. dollar in the latter quarter of 2011, for example, eroded the competitiveness of Indian exports.
- *The price inflation of the economy:* has a bearing on domestic consumption. Higher prices force people to tighten the purse strings and reduce expenditure on such discretions as travel, holidays, eating out, and consumption of high end products. High inflation also makes it difficult to realistically peg the cost of a long-term project. In such situations investments are made in safer overseas markets rather than at home.
- *Balance of payments:* (foreign exchange reserves held by a country) affects the investment climate in a country.

Social factors

Social factors impact the consumption patterns, lifestyle of people. Organisations have to tailor products to people's tastes at the same time social factors have an impact on the marketing and branding of the products. In India and China the consumption of gold in the form of jewellery is at a peak. Traditional jewellers in India did not offer gold according to its purity. Today branded gold jewellery is popular and the sale of branded jewellery is growing faster than traditional jewellery.

Among social factors organisations are keen to know about are the demographic shifts in the population, the changes in family size, family composition, the role of children in buying decisions, migration, trends towards literacy, lifestyle changes, social norms, and so on. Examples of the opportunities or threats created by social changes include:

- *The social norms and mores affect consumption*: One example is the cigarette and tobacco industry. In the 1960s smoking was not only socially acceptable but also considered chic and stylish. The demand for sophisticated tobacco products created hugely successful brands like the 555, Marlboro and Dunhill. The U.S.-based companies were very profitable and in the developing countries these brands had high aspiration value. As the awareness about the harmful effects of smoking was scientifically established and the now-mandatory pictorial warnings about the harmful effects of smoking on cigarette packaging was introduced, the brands lost their sheen and consumer fascination reduced. The increasing health consciousness among the consumers opens the doors of opportunity for manufacturers of healthy and light snacks, carry-home food, health clubs, and exercise equipment.
- *The increasing level of literacy especially among the women spurs demand in select segment*: It is a crucial determinant for the number of women joining the work force. As more women join the workforce they have more money to spend on women's health and family welfare products/services, domestic appliances, health insurance, education services, personal grooming products.

In India and elsewhere the rising number of women in the workforce has meant an enormous increase in demand for such products and services. As a growing number of women join the higher echelons in the corporate sector, organisations reconfigure their products and services.

- *Migration from rural to urban areas*: is an opportunity for housing, medical services, schooling, public transportation and so on. The migration also makes available cheaper and abundant labour for farms and industry. In migrant communities entrepreneurship is also common and the affluence that it generates leads to more remittances back home. There is an increase in consumption of products and services such as gold, cars, farm equipment, education, television sets, branded clothing and saving instruments, such as mutual funds.
- *Demographic shifts of population*: affect the consumption, saving, aspiration levels and manpower availability. Today India and China are relatively young countries, demographically. These and other Asian countries are big markets for products synonymous with youth culture such as jeans, sporting gear, educational services, entertainment, fast food, and fashionable mobiles and accessories. On the other hand the aging population means opportunities for business that can tailor products for the aged generation holidays, recreation, medical and nursing care, and home equipment suited to the physical needs of the aged, as would be in the case of Japan.

Political factors

Political factors affect tariffs, sectors open for private initiatives in business, demand , equitable access to resources and inputs (government controlled), and access to transnational resources(determined by foreign policy and relations). All in all the government is the architect of economic policy and foreign policy therefore it dominates choices available to corporations.

The political factors refer to the government, the legal framework for the business and the political climate of the country. Of these three factors, the political ideology creates the conditionality, conducive or detrimental to business. Political stability of the country also plays an important role in creating and boosting investor confidence. The local and foreign organisations face lesser uncertainty in Asian regions. Governments have longer tenures. However, in Asia there is a trend towards coalition politics and while accommodating the demands of the coalition partners, economic policies become volatile. In Asia, governments are more likely to be involved in business as investors, partners, regulators and key actors than in the developed western economies. Government’s interventionist role is likely to be greater in North Korea, Vietnam, India, and China and moderate in Singapore, Malaysia, South Korea, Hong Kong and Taiwan. In India, the Government was not very pro-business till the early 1990s. Emphasis was placed either on the public sector or the small scale sector in the belief that these sectors could spur growth more than big business could. The economic reforms of the 1990s have created many opportunities for business. Business organisations could diversify into areas hitherto reserved for the small scale sector or the public sector. The reforms saw the privatisation of important sectors such as telecoms, insurance, and banking. Broadly, these factors include all those within the ambit of the political, legal and government factors. Other than the role of the government as the chief architect of economic policy few other roles of government are important for business. Some of the important politico-legal factors are:

- *The role of the government as a buyer:* Governments are the largest buyers of some products such as military hardware, paper, institutional housing, computers, pen and paper clips. . In India, where railways are government-owned and controlled, the manufacturers of electric wiring for railways depend upon the government for purchases.
- *The role of Government as a regulator:* Governments regulate business by making laws for competition, customer protection, investor protection and protection of whistle blowers. The dominant tilt of the government as being pro-business or anti-business is reflected through such laws. Governments' regulation also protects domestic business from the foreign firms.
- *The role of government foreign policy:* Policy of the government in areas other than economic and investment domains also influence organisations. Foreign policy determines the diplomatic relationship with other countries, in the process opening or restricting some markets. The Indian Government did not have diplomatic relations with the South African Government while it practised apartheid. At that time, Indian companies could not import diamonds or other products from South Africa even though it was economically beneficial to buy from South African vendors.
- *Regional Cooperation:* There is an increasing trend towards regional cooperation among nations. This facilitates trade relations, geographic expansion and development assistance to others in the region. ASEAN is a dominant regional block in Asia.

Technology

Technology interfaces all the functional aspects of the organisation. It can either create conditions conducive to lowering costs or making the products exclusive, provides a platform to access newer markets (e-marketers can access larger number of consumers) and create awareness among geographically dispersed consumers about products and services. Technology development in one business can have a ripple effect on other businesses creating unthought-of opportunities or threats.

Apple's iPhone is an example of a sophisticated product based on technology leadership. Product and service breakthroughs spawn entirely new industries computers, artificial intelligence, and genetic farming are industries which are technology-based and capable of offering not only advanced products but also solving many problems. Technology is an important external factor to consider because it affects:

- *The product life cycle:* Technology makes some products redundant even though the customer need may be there as we saw in the example of the horse drawn carriage and the kerosene lamp. New products replace older ones; for example, the stencil mode of copying documents was replaced by photocopiers.
- *The distribution of goods and services*: The Internet has opened a cyberspace window to shopping and buying products ranging from books, cameras, apparels, holidays, to services like railway and airline tickets, and banking. The Internet is changing the way people buy as well the extent of service they require. For any business that aims to sell to youth it is imperative today to have an Internet interface for display, buying, and selling. Organisations therefore, have to scan for not only technologies that influence their industry, but also those that have the potential to change the way they do business even if the technology has emerged elsewhere. In your case, technology-enabled teaching has made this course possible.
- *Cost dynamics:* Innovations bring to the fore new products/processes which reduce the cost of production or improve the quality and finesse of the product. These have the potential to alter the competitive landscape of an industry.
- *Creates opportunities for other industries*: The new multimedia mobile services such as data entertainment and text has also been the force behind either fresh development or up-scaling of technology of secure networks, memory chips and processing power, smart cards, software compatible with billing, mobile banking. Other industries have also grown.

International environment

The international environment is more complex, heterogeneous and competitive than the domestic situation. Globalisation has made the international environment an important external factor to consider, particularly for companies which have operations across different countries. All factors that are important in the domestic markets apply to international markets as well with an increased complexity and uncertainty.

There are vast differences in the cultural, legal, social, educational and technological features other than differences in government policies and controls. A significant feature of globalisation is the integration of the economy. The Euro crisis and the slowdown of the U.S. economy are factors that affect international trade and global economic trends. Organisations have to study significant economic, political, and cultural trends overseas. The anti-globalisation sentiment is likely to influence some government policies, particularly in those countries where elections are to be held. Governments would want to be seen as being sensitive to the local sentiment and announce measures to boost local industry. When governments restrict jobs for foreigners, they may satisfy populist sentiment but the move has a negative bearing on the flow of expertise and competence.

Case study

Case study

India and China have been dominant tea-growing countries. Tea exports are a substantial foreign exchange earner for both the countries.

These countries have a tradition of drinking tea. There are varieties of tea brewed in different styles. Over the past ten years in both countries coffee has emerged as a favoured brew. The increase in the consumption of coffee in the United States where it is the preferred brew has been declining. Coffee consumption is expected to grow at the rate of 3 per cent in the United States. In China the rate of growth of coffee consumption is expected to be 15 per cent. Starbucks has been operational in China since 1999 and by 2014 plans to have opened 1500 outlets in the country. In 2012 Starbucks entered India in collaboration with Tata, a mega conglomerate with coffee plantations in Southern India. It has ambitious growth plans to open 50 stores by the year end. According to the Indian consulting company Technopak, coffee consumption in India is growing at 25 per cent per annum presenting a huge opportunity to Starbucks as well as local chains such as Cafe Coffee Day.

The coffee craze in both the countries is driven by the younger urban population which perceives coffee to be more sophisticated and fashionable. Coffee houses as opposed to the tea houses are seen as the “happening” places.

Economic growth has put more disposable income in the hands of the young. The coffee cauldron is also brewed by popular serials transmitted globally that hint at coffee being the “cool” brew. The globalisation of consumption favours coffee.

Analyse the reason for the increase of coffee consumption in India and China. You may use information from official company websites in your analysis.

Activity 2.2

Activity

Read about Starbucks' entry to the Indian and Chinese markets. Search different sources of information such as company websites, coffee and tea board websites to collect information about production, consumption, market size exports, press reports for buyer behaviour and other details. On the basis of the information prepare a comprehensive case on coffee consumption in India and China as an appendage to the case above.'

Are there any other industries you can think of where consumption is following the global trends other than film and music entertainment? Conduct research about the factors that may be driving the change and present a report to your supervisor in a case form.

Industry analysis

Organisations operate within an industry. The macro factors influence the industry as well as the behaviour of competitors in the industry. While conducting the TOE analysis the organisation studies and analyses the industry structure (which is one of the determinants of industry profitability), the competitor behaviour, nature of competition and industry life cycle. This analysis is useful to assess the current profitability as well as to chart future direction.

According to Michael Porter (1980) an industry consists of a number of organisations offering products or services that are close substitutes of each other. The products satisfy broadly the same need of the customer. The other organisations that offer the same product or service are the closest competitors. Organisations like Dell, Lenovo, HP, IBM and Apple offer products that enable a consumer to browse the Internet, play games, listen to music, load, store and display data. (They belong to the personal computer industry). It would be interesting for you to discover the respective countries to which these organisations belong to.

An industry consists of:

- the buyers of the products,
- the various suppliers of resources to the manufacturers/service providers,
- the competitors,
- the likely competitors who can be attracted if the profitability prospects are attractive,
- substitute products that may appeal to the consumer because of some new strength,
- complementary products that make using the main product easier.

A sector is larger than the industry and has many organisations. For example the aviation sector would consist of the aircraft manufacturers (Boeing, Airbus, Bombardier) airlines, (Air Asia, Singapore Airlines, South West Airlines, Cathay Pacific), airports, (main international airports, feeder airports, private airlines' airports), the organisations that develop and operate airports (for example: Fraport AG), (airline catering organisations (such as Skychef), the different organisations that train airline cabin crew, ground handling staff, the unions and others. Each belong to the respective industry and cumulatively belong to the aviation sector.

Activity 2.3

Activity

Applying industry and sector concept

The telecommunication industry is one of the prominent industries in your country it includes the service providers, the tower companies, the hand set manufacturers, and so on. Based on your understanding of the concept of industry and sector, map the telecommunication sector of your country. The following questions will help you to map the sector.

- What are the different types of organisations that belong to the telecommunication sector? Write the names of these organisations.
- Which segment of the sector do they belong to?
- In the given industry who are the dominant three players?
- How are different organisations aligned with each other?

This activity will enable you to understand the interrelatedness between sector and industry.

Five forces model

The five forces model was developed by Professor Michael Porter of the Harvard Business School in his book *The Competitive Strategy Techniques for Analysing Industries and Competitors (1980).* Since then it has been extensively quoted across the academic world as a tool for analysing the structure of industries. Five of the constituents of the industry mentioned above are from Porter's list of industry's structural forces.

According to this model (see **Figure 2.1**) the five forces "determine industry profitability because they influence the prices, costs and required investment in an industry." According to Porter the five forces explain the structural determinants of the industry and help to explain the profitability of the industry in conjunction with immediate competitor behaviour. The five forces are:

- The suppliers of raw materials and services.
- The buyers - who are they and how do they buy?
- The extent of completive rivalry in the industry.
- The role and availability of substitutes.
- The likelihood of new competition.

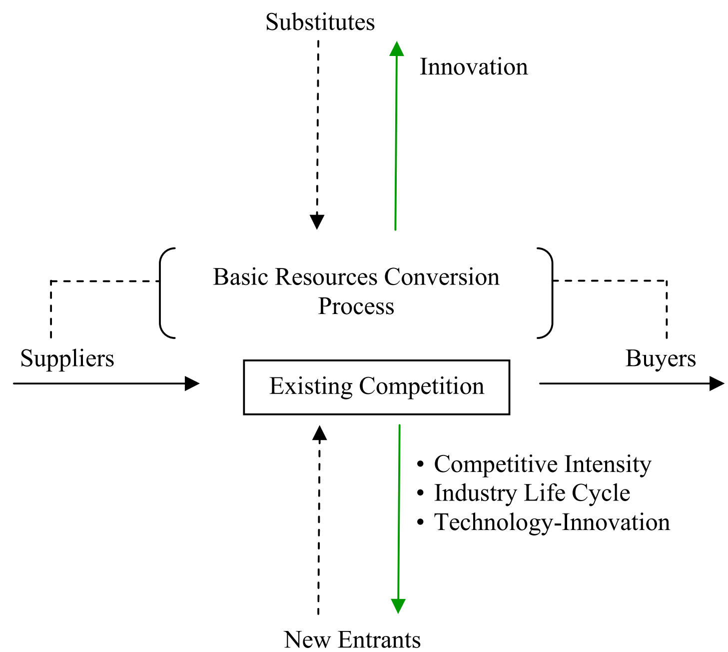

Figure 2.1: Competitive Advantage

Adapted from: Porter, Michael. (1980) *Competitive Advantage: Creating and Sustaining Superior Performance.* The Free Press; New York.

The suppliers

Suppliers play an important role in determining industry profitability. The suppliers have the capacity to control the cost/quality of the inputs. Labour is also an input and the supply or short supply of highly skilled labour has the power to bargain, affecting the profitability. The more dependent an organisation is on its suppliers the greater is the difficulty it faces in shifting/ switching to another supplier. High switching costs may compel an organisation to stick with a supplier to whom better alternatives may be available. For example using the suppliers' engineering support may make it difficult to switch to another one.

According to Porter the suppliers are most powerful when:

- The product sold by the supplier has no substitute,

- The product is vital for production of the organisation's product/s,
- The organisation is not a major buyer of the supplier's product,
- The costs of switching suppliers are high,
- Suppliers can turn producers, and
- The organisation cannot enter the domain of the supplier.

Intel is an example of a powerful supplier to computer manufacturers. Intel's chips power about 80 per cent of personal computers. Intel enjoys a size advantage as well as the leadership advantage over other, smaller manufacturers. Intel, by virtue of its size, can determine the price and terms of payment advantageous to it. Suppliers who enjoy economies of scale are in a better position to offer cost-competitive products but if there is a shift in technology that enables a different manufacturer to offer a product that is more compatible with the buyer's cost dynamics or competitive position that the larger manufacturer must either shift to the new technology thereby losing its competitive advantage or be locked in and continue to sell till there are buyers.

Can the organisation offset the dominance of the buyer? It can by backward integration, or by adopting methods that remove or lower switching costs.

The buyers

The buyers either enforce a better price or better quality depending on their competitive position. According to Porter the buyer is in a strong position when:

- There are many small disaggregated suppliers offering the same product,
- The order quantity is large enough to enable buying from many suppliers,
- The suppliers depend on the buyers for large segment of their sales,
- Switching cost for the buyers is low and it is easy to switch from one vendor to another, and
- When it is possible for the buyers to decide to "make" instead of "buy".

The buyers can be dominant distributors such as Wal-Mart for manufacturers like Proctor and Gamble, or individual buyers such as customers for cars, or a major car manufacturer for a steering component of a car. In the case of retailers like Wal-Mart they are a platform from which individual buyers would buy the products of Proctor and Gamble. Who is more likely to extract a better price from the manufacturer you as an individual buyer or a large dispersed retailer like Wal-Mart?

In the case of some products the retailer exerts an influence on the buying decision at the time of purchase (for example: cosmetics, audio and mobile accessories), in that case the retailer can exert pressure on the supplier.

Existing competitive rivalry

In a given industry competitors try to out-manoeuvre each other and gain a higher market share. A higher market share is presumed to lead to higher profitability. According to Porter, competitive rivalry is intense when:

- The stakes for all the competitors are high. To meet their strategic objectives the organisations may be willing to forgo profitability for expansion leading to intense rivalry.
- High exit barriers. Exit barriers can be because of assets customised to a particular industry, interrelationship among units, pride, employee loyalty, or government restrictions.
- If the products are undifferentiated and switching costs for buyers are low, rivalry is intense.
- Large capacity addition leads to price cutting which escalates the rivalry.
- Slow industry growth rates prompt organisations to indulge in price and non price-competitive actions leading to intense rivalry among organisations.
- A large number of competitors without any one enjoying a leadership status fight each other and retaliate vigorously.

To gain higher market share organisations can lower price, offer a better quality product, improve the after-sales service, add freebies, improve the product performance, increase advertising, or intensify the direct selling effort. Each of the functionally driven activities consumes resources and escalates costs of operations. The action of one organisation is likely to be improved upon by the others and the intensity of rivalry in the industry increased. The increased rivalry reduces the profitability of the industry. In intensely competitive industries price wars are common and may lead to a shakeout in the industry. Price wars are more common in commodity type industries where the product differentiation is low.

Fare wars in the airline industry are fairly common in Asia. The fare wars erode the profitability of the industry. In most countries cartelisation to protect the fares or watch common interest is controlled through competition or similar law. (Find out the law in your country that restricts monopolies/unfair competition/cartelisation).

The role and availability of substitute products

Substitute products can play spoil sport for industry profitability. If the substitute product offers a substantive price or performance advantage the organisation has to decide whether to take up the substitute at one go or gradually.

Substitute products can disrupt the equilibrium or change the industry structure if:

- The recurring costs of use of industry product are lower leading to cost advantage.
- The substitute product is vastly superior in performance.
- The substitute product has low installation or maintenance costs and switching costs are low then there is acceptability of the substitute.

In a given industry there are products that can be substituted for the existing one. When two products (product A and product B) can be used to replace the other if the price of one increases, consumers can buy B whose price is lower than the price of A. There can be perfect or partial inter changeability of the product. Substitutes can be different in technology-price composition but serve the same need. Coal and natural gas are different but can be used for the same purpose; compact discs and cassettes are different but can be used to store music. Consider the example of the replacement of human labour in hazardous industry by industrial robots the robots work faster, there are fewer accidents, and reduction in the loss of limb and life. The industry can increase productivity and profitability.

Another extreme example is the likely substitution of going to a movie by Internet browsing, or visiting the opera, if you had an hour free and were contemplating any of the three options. Your need is entertainment and enjoyment all three can provide that, but have divergent platforms.

Organisations can look for substitute products or can develop them through research and development or the industry as a unit may look for a substitute product or in some cases the government may compel a shift towards the substitute product, for example in India, the CNG bus service (replacing diesel as a fuel) happened because of government directives.

Potential entrants

A potential entrant is one who eyes the given industry anticipating higher returns. The entrant may bring new technology or other resources to the industry. The success or failure of the entrants would depend upon the reaction of the other players in the industry and the entry barriers in the industry. The existing players in the field would not like a new entrant as the new entrant can erode the profitability of the existing players.

Barriers to entry imply that the newcomer has to spend large sums of money to counter the entrenched positions of the existing players. The existing players may be enjoying economies of scale. For example in car manufacturing the substantive investment in the plant and the economies of scale enjoyed by the entrenched companies ensured that in the U.S. market there were no major newcomers till the advent of the Japanese.

The entrenched players erect barriers through product differentiation and brand loyalty. Cosmetics and jewellery designer wear accessories are industries where brand loyalty is tough to alter. If the switching costs from the existing players to the newcomers are high the users are unlikely to switch to the new suppliers. The insulation from competition makes the entrenched players happy, but are the high entry barriers also in due course going to act as exit barriers? A declining industry with the exit barriers will not only be a threat to profitability but may make divestment of capital difficult.

Potential entrants also have to assess the extent to which the intellectual property gives an added advantage. In the hospitality industry location is important.

Through discussion and the examples it is clear that the threat of new entrants can be minimised if the organisation invests in economies of scale, brand building, creating intellectual advantage, and capitalising on access to strategic resources. Conversely, a newcomer can try to claim a share of the existing industry. It would depend on the growth potential of the industry if the newcomer or the entrenched player would seek synergies with other industry.

From Porter's model, an organisation can gain an insight about the likely conduct of competitors given the structure (regulation of supply and demand) of the industry. It would be worthwhile to refer to Chapter 3 A Framework for Competitor Analysis in Porter's book "*Competitive Strategy: Techniques for Analysing Industries and Competitors.*"

Strategic groups

Organisations in a given industry compete in different ways. Organisations can compete on the basis of differentiation of products, specialisation, through channels, quality differential, technology leadership, service differentiation, integration. If one were to study the way organisations compete, then one would also identify clusters of those organisations that have similarities. Such organisations that compete in a similar fashion and can be bundled together are a strategic group. For example Emirates and Singapore Airlines compete using similar strategies on advertising, customer relationship, quality of service, in flight entertainment, in contrast to Air Asia. Similarly General Electric would compete differently from the appliance maker who manufactures for a private label. The strategic groups therefore have different bargaining power, threats of substitutes in a given industry.

Those organisations that have similar ways of competing constitute a strategic group. It is difficult for organisations to move from one strategic group to another. A strategic group is an intermediate position between looking at the entire industry and each organisation separately.

Analysis of a strategic group gives a broad idea of competitive strategies making it easier to spot a gap if there is one.

Industry life cycle approach

As organisations compete with one another the competitive dynamics change. There is a change in the number of competitors, the competitive thrust, profitability, intensity of rivalry and the emphasis on innovation. These changes have been shown in the industry life cycle which is an S-shaped curve similar to the product life cycle curve. The main life stages are – embryonic, growth, shakeout, maturity and decline. **Figure 2.2** shows the industry life cycle.

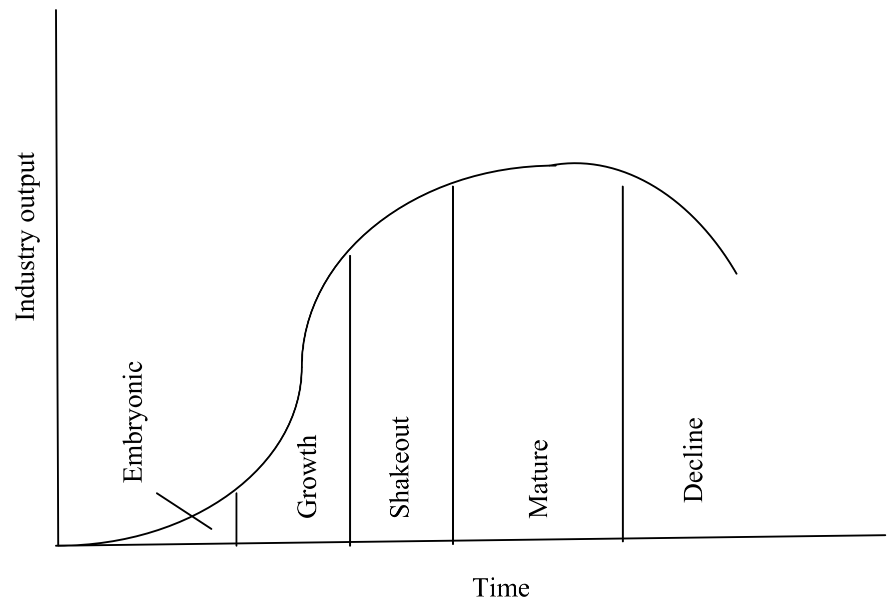

Figure 2.2: Industry Life Cycle

The embryonic stage is the initial stage. Competition is not severe. The early entrants are busy creating awareness about the product/service, educating the customers. The personal computer industry of the early 1970s was in this stage. Investments are made in distribution channels and designs. Organisations that can set up distribution channels and resolve design problems faster, gain advantage over the other players. The next stage is the growth stage where the demand is expanding rapidly. Scale economies happen and prices fall. Customers are more aware of the product and rivalry is building up though not intense. If the growth is rapid new entrants can be absorbed.

The growth stage is followed by a phase of intense rivalry where demand begins to saturate. Therefore, the competitors have a fierce battle based on price wars, capacity within the industry grows but the demand does not keep pace. The unviable organisations lose out in this phase.

As the demand slows and is reduced to replacement demand companies focus on cost cutting. Those organisations which have been able to have a low cost position and brand loyalty survive. If there is a high rate of technological obsolescence and it does not make sense for existing players to invest in technology or if the demand for the product is going down because the consuming segment is declining, the industry enters the decline phase. There is excess capacity and the exit barriers can precipitate price wars again. The industry life cycle analysis enables managers to understand at what point to alter their strategies. For example, a prudent manager would change gear during early growth and invest in technology to avoid the intense competition of a shake-out.

Competition: The emerging scenario

Reflection

Should an assessment of the competitors be restricted to the use of Porter's five forces model? Comprehensive as the five forces analysis may be, it does not factor in the blurring of the boundaries between the industries and the role of innovation and creativity in altering the industry landscape. The convergence of technologies creates different landscapes for an industry not captured by the five forces model The emerging competitive landscape questions few traditional notions of competitive positioning. The competitive war is for attracting and retaining customers. The traditional view has been to consider the customer as the recipient of the value proposition of the organisation. The traditional concept of value is that it is created for the customer who is the recipient of the value but not an active participant in the creation of the value. The blurring of the boundaries between products/ technologies/ industries creates different products and experiences. The reactive approach to competition analysis may not capture the overlaps and the convergence.

The contemporary customer is better informed, experienced, educated and networked than customers used to be. According to the management thinkers C.K Prahalad and Venkatramaswamy (2004), competitive advantage of the future lies in co-creation of customer experience and value. The interaction between the customer and the organisation creates differently configured and not merely better or superior products but the improvements are multifaceted and not linear extrapolations of the pre-existing product. The key building blocks of competitive advantage are DART **dialogue** with customer, the **access** to the customer, willingness to take **risk** for co-creation and maintaining **transparency** in the co-creation process.

This implies that sustained competitive advantage would need the hardware of technology analysis but also the software that makes a rapport with the customer beyond loyalty. There is an effort to reduce the tension at the points of interaction between the organisation and the customer.

The foregoing discussion informed us about what the organisation may have to study. It now has to decide the modality of the analysis. The key decisions pertain to- how to design the study, who will study and the post-study input to decision making.

How to appraise the external environment

What methodology is to be used for appraisals?

Should an appraisal be an in-house exercise or should it be an external consultant based exercise?

The answer to this depends upon the availability of the skills to conduct the external appraisal within the organisation. There are different agencies that collate industry specific data, track trends in consumption, (for example the Economist Intelligence Unit) that can be used by the organisation. The task of drawing conclusions from the externally available data is for the top management.

Organisations can appraise the environment in a formal systemic manner or in an informal manner. An informal approach to appraisal is possible when the turbulence levels in the environment are very low. In such situations seat-of-the-pants and close group discussions approach to appraisal is more of a reinforcement of what key managers think and perceive.

Forecasting of future sales and expert opinion are the techniques that are used when an organisation operates within a relatively stable, predictable environment. In such situations managers may not take into consideration technology changes, or criticality of resource availability. The mindset is not oriented towards preparedness for uncharted waters.

When organisations operate in environments that are turbulent, managerial acceptance of ambiguity and unpredictability is a prerequisite to appraisal. In more volatile environments organisations can use econometric models, impact matrices or scenario building. It must be remembered that an element of subjectivity would be there when assessing the factors that are deemed to be of relevance and when any types of weights or percentages or probability is applied to the possibility of their occurrence. In these approaches the best and worst case scenarios are drawn up and contingency plans for each are drawn up so they create at least a mindset for preparedness in a worst-case scenario. The scenario building approach was developed by the Shell group. Its business of oil exploration faces many discontinuities and the investment to be made in exploration at a site is substantial. There are dangers of government interference, environmental groups' disturbances, quality of the exploration, quantity of exploration material, exploration disasters, and natural disasters. Shell builds up scenarios ranging from the most-possible to the least-possible and draws contingency plans for the same to conduct its high-risk business.

In scenario building, first the high-impact high-uncertainty factors in the environment are identified.

Second, the possible futures in terms of two opposing variables are identified, such as favourable unfavourable. As a third step, possible scenarios are built up. Contingency plans for each are drawn up.

The organisation can make use of information collected by its managers during interactions with other managers at industry forums, conferences or seminars, during interaction with relevant policymakers as mandated from time to time, customer feedback and reports, employee reports, or company databases. It may also gather information from such diverse sources as industry reports, research publications, commissioned studies, mass media reports, government publications, annual reports of the competitors, and commercial data bases.

In real life many proactive organisations involve the functional managers in the task of appraisal. They are the ones who have first-hand information about the business scenario. Different formats are used to facilitate contribution and discussion during which not only are the possibilities within the environment explored but simultaneously the organisation's possible response is also discussed. As churning of ideas across functions takes places the perception about the environment and the organisation is shaped far differently than what it would be if the exercise was done without such involvement. Undoubtedly such an exercise requires top management support. As you will read through the course manual you will notice that many activities require top management attention involvement and commitment, this reinforces the nature of top management as discussed in Module 1.

Activity 2.4

Activity

Draw the scenario for book publishing anticipating a threat from the electronic publishing.

The possible futures you may consider are rapid changes/ moderate changes in publishing; favourable policies of government towards publishing/ unfavourable policies; high and increasing costs of book publishing/stable cost in electronic media; environment cost of paper/ environment cost of electronics; public support for books versus electronic media.

Discuss the possible futures with at least ten people who are readers/librarians/associated with book publishing. On the basis of this draw four to five scenarios. Present the one which you feel is the most plausible with conditionality from the above list.

Who is to appraise the external environment

It is best if appraisal is conducted by the key manager of different verticals. They have a sense of the business and are better equipped to map the trends than a centralised planning department. The challenge is to not let appraisal become too integrated with the day-to-day reporting that it loses its focus nor let it become too far removed from business realities. At times the environment appraisal will signal totally different and new information. An inexperienced manager may either be swarmed by the information, or may totally miss the relevance of the signals. The managerial mindset about making sense of information, having a capacity to not let one's own judgement and experience influence interpretation of signals that are different from expectations during appraisal. Crossfunctional teams can also be formed and techniques like brain-storming may be used to prevent a 'silo' mindset-oriented analysis.

Module summary

Summary

The external analysis is an important part of the strategic management process. Assessment of the opportunities and the threats enables the managers to take informed decisions about those aspects that have a bearing on the organisations long term sustainability and continued profitability. Managers conduct an industry analysis or focus on strategic groups to understand and improve on the organisation's competitive position. Managers also analyse and interpret the implications of changes that take place in the social, politico-legal, economic, technological and international areas to assess the emergence of opportunities and threats. The implications of the development that takes place will be most clear if it is organised in matrices that clearly depict the cause and the effect relationship among select variables. The appraisal must be able to answer the following questions:

- What is the factor that is external to our boundaries and critical to the long term survival of the organisation?
- What is the relationship of the factor with other environment factors and how can the organisation influence the factor?

To be proficient at the analysis, managers need to develop the skill set to be proficient at studying, assimilating and measuring the impact of different factors. Environment must be studied but not be regarded as an intimidating factor. The manager must foremost remember that a well-developed strategy shapes the environment as well.

Assignment

Assignment

Proposition: "Too much of analysis may not necessarily lead to a comprehensive analysis."

Task: In view of the proposition cited above, answer the following:

a) To what extent should an organisation analyse the environment?

b) How do managers enforce not doing too much analysis?

Proposition: "Industry Structure is a determinant of profitability of the organisations."

Task: Accept or refute the given proposition. In case you refute the preposition put forward the other aspects that should be considered as being relevant for analysis of future profitability.

Assessment

Assessment

Enumerate the merits and demerits of appraisal by managers versus external agencies.

You may base the comparison on four broad factors:

1. Knowledge about the organisation,
2. Knowledge about the external environment,
3. Methodology to conduct the study,
4. Capability of analysis and application of results.

You will draw the sub-factors on the basis of discussion with other colleagues and present your findings in matrix form.

References

Reading

Porter, M (1980). *Competitive Strategy : Techniques for Analysing Industries and Competitors*. New York: Free Press.

Prahalad, C.K & Venkatramaswamy. (2004) *The Future of Competition: Co-creating Unique Value with The Customers.* Boston, Mass: Harvard Business School Press.

Further Reading

Reading

Andrew, D & Singh, K. (2006). *Mastering Business in Asia: Strategy for Success in Asia.* New Delhi: Wiley India Ltd.