Chapter 4

Strategic analysis: External Environmental Analysis

Chapter learning objectives:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
</table>
| A.1 Evaluate the influence of key external factors on an organisation’s strategy. | (a) Evaluate the influence and impact of the external environment on an organisation and its strategy. | • Different organisation environments (including profit and not-for-profit organisations).  
• The key environmental drivers of organisational change and their prioritisation.  
**Note:** The emphasis should be on the evaluation and prioritisation of the environmental drivers specific to the organisation and not upon the production of a generic PEST analysis. |
| B.1 Evaluate the process of strategy formulation. | (b) Recommend strategic options. | • The identification and evaluation of strategic options, including the application of the suitability, acceptability and feasibility framework. |
| B.2 Evaluate tools and techniques used in strategy formulation. | (a) Evaluate strategic analysis tools. | • Audit of key resources and capabilities needed for strategy implementation.  
• Forecasting and the various techniques used: trend analysis, system modelling, in-depth consultation with experts (e.g. the Delphi method). |
1. Introduction

Purpose of environmental analysis

- To characterise the environment that can influence the business.
- To identify threats and be prepared to handle them appropriately.
- To identify opportunities and be prepared to benefit from them in a timely manner.
- To identify competitive strengths and weaknesses.
- To recognise competition in the market and how to compete more effectively.
- To identify stakeholders and what they require from the organisation.

Drawbacks of environmental analysis

- New technology constantly changes the competitive environment by introducing new products and their placement in the markets.
- A continuously weakening global economy has led to problems with the predictability of demand.
- An increasing number of factors affect an organisation as national borders blur.
- The emergence of high-growth economies (BRIC).
- Regular environmental analysis is necessary if it is to have any relevance to the organisation.

Tools
2. PEST analysis

- Assesses the general environment.
- Specifically considers market conditions, i.e. growing or declining.
- Can also be used to identify opportunities and threats (SWOT).
- Focuses on four parameters:
  - Political factors
  - Economic factors
  - Social factors
  - Technological factors
- Other variations of PEST include:
  - SLEPT (social, legal economic, political, technological).
  - PESTLE/PESTEL (political, economic, social, technological, legal, environmental).
Drawbacks of PEST analysis

- PEST will quickly become irrelevant in industries where conditions change quickly.
- The opinions of different managers limit the objectivity of the analysis.
- It is impossible to identify each and every factor that is important for an organisation.

3. Porter’s Five Forces analysis

- This model focuses on conditions within a specific industry.
- The five forces decide whether or not a business in that industry is profitable.
- Generally, the greater the forces, the lower the prospective profit potential.
- Success lies in minimising these forces so as to increase one’s profit potential.
Power of buyers

- This is the bargaining power.
- Bargaining power is high when:
  - There are many buyers
  - There are many suppliers
  - Switching costs are low

Power of suppliers

- This is the bargaining power of suppliers, i.e. the influence of suppliers on the customer.
- Power is high when:
  - There are few suppliers, i.e. a monopoly
  - The product is crucial to the customer
  - Switching costs are high

Threat of new entrants

- This is dependent upon the barriers to entry in an industry.
- An organisation must know whether it is trying to enter or trying to prevent others from entering an industry.
- The barriers need to be identified.
- If the organisation seeks to enter, they will wish to be able to overcome these barriers.
- If it is trying to prevent others from entering, it will try to intensify these barriers or paint the barriers as too difficult to overcome.
- Some of the barriers may be:
  - Economies of scale
  - High capital requirements
  - Difficult access to distribution networks
  - Long-standing relationships of the companies in the industry
  - Expectation of retaliation from market leaders
  - Cumbersome legal requirements
  - Strong product differentiation
  - High switching costs for customers
**Threat of substitutes**

- Substitutes fulfil essentially similar needs or uses.
- Substitutes may be in direct or indirect competition.
- For instance:
  - Juices or soft drinks
  - Luxury car or luxury bike
  - A vacation or a home theatre

**Rivalry among competitors**

- Competition among similar products, e.g. Coke and Pepsi
- Competition may be intense where:
  - Competing organisations are of similar size.
  - Competitors have a similar market share.
  - The market is mature – the further along the life cycle, the greater the competition.
  - Differentiation of products is low, leading to greater rivalry on price.
  - Storage costs or capacity are high, necessitating the lowering of prices to increase sales.
  - There are high exit barriers, generating a fiercer need to stay and compete.

**Drawbacks of Porter’s model**

- Customers are perceived as competitors (power of buyers).
- Its usefulness is low in dynamic industries where circumstances keep changing rapidly.
- It is difficult to apply to companies with specific differentiated competences.
- It is important to consider influential government actions in addition to these five forces.
- This model is based on the assumption that there are no alliances in business, which is false.
- Not suitable for not-for-profit organisations as it focuses on profitability.
5. **Industry life cycle analysis**

- There are several stages in a product’s life cycle.
- This analysis allows the implementation of different strategies at different stages to gain maximum benefit.
- This life cycle analysis can be applied to both products and industries.
- The life cycle comprises the following stages:
  - Introduction
  - Growth
  - Maturity
  - Decline

### Introduction stage

- New product introduced in the market.
- Low awareness of product.
- Low initial demand for new product.
- Production is, therefore, low at this stage.
- Costs are likely to be high at this stage, e.g. research & development and promotional costs.
- Competition is low.
• Pricing strategies could be either:
  – *Penetration price*: setting a low price to gain market share.
  – *Price skimming*: setting a high price to gain maximum benefit in the initial stages.

**Growth stage**

• Awareness of product increases.
• Demand levels increase.
• Market as a whole grows.
• Production levels consequently increase.
• This might result in economies of scale.
• There might be price competition as competition grows.
• New competitors enter the market.
• Profitability and cash flows increase.
• It is likely that initial costs are recovered.
• It is important to develop brand loyalty at this stage.
• Products may be differentiated as more rivals enter the market.

**Maturity stage**

• Market growth reduces.
• Market becomes saturated.
• Competition becomes fiercer.
• Market share can only be increased at the expense of another.
• Extension strategies are sought for the product.
• Market niches may be developed or exploited.
• New product variations may be developed.

**Decline stage**

• Market shrinks.
• Buyers reduce.
• Demand lowers.
• Smaller suppliers exit.
• Prices are lowered (price cutting) to gain any share from leaving competitors.
How to benefit from life cycle analysis

- Have a mix of products at various stages.
- The cash flows of a mature product enable the funding of a new product.
- Profit from the novelty of a new product.
- Profit from low costs and economies of scale of mature products.
- SWOT is likely to be different at different stages.
- Adapt strategies according to the stage of the product.

Advantages of life cycle analysis

- Better strategic planning – more focused strategies can be implemented according to the stage, for instance, pricing strategies can differ at different stages.
- Helps budget better – helps understand the stages where costs will be incurred and where inflows can be expected.
- Proactive strategies – strategies can be implemented at the first sign of the product moving to the next stage for maximum profitability.

6. Competitor analysis

- Seeks to understand competition.
- Aims to define a company’s own position relative to its competitors regarding:
  - Competitive advantage
  - Current strategies
  - Prospective strategies
  - Competitor behaviour
IDENTIFYING COMPETITORS

Competition can be classified into four levels:

- **Brand competitors** – selling similar products to the same market segment e.g. burger from Hardees or Johnny Rockets.
- **Industry competitors** – selling similar products to different markets e.g. McDonald's in India and KFC in Pakistan.
- **Form competitors** – selling different products that cater to the same need e.g. heavy bike or sports car.
- **Generic competitors** – selling different products but aiming for the same income e.g. spending on a vacation or home theatre.

ANALYSING COMPETITORS

- In order to predict the competitor's strategy.
- To help foresee the competitor’s response to our strategy changes.
- Need to determine the following:
  - The objectives of the competitor
  - The competitive strategy of competitor
  - The competency of the competitor
  - The assumptions held by the competitor

COMPETITOR RESPONSE PROFILES

- How a competitor responds to competition can be classified as:
  - Laid back: no response
  - Tiger: aggressive response
  - Selective: responds in certain cases
  - Stochastic: unpredictable
7. **Global markets**

**Reasons for entering global markets**
- Further expansion is not possible domestically.
- Emerging opportunities in foreign markets.
- Lowering of trade restrictions in foreign countries.
- Shareholder pressure to increase returns.

**Risks in global expansion**
- Cultural differences cannot be ignored.
- Exchange rate volatility considerations.
- Different cost structures and factor quality.
- Level of competition in the foreign country.
- Political stability and government involvement.
- Conditions for entering the foreign country for trade.

**Advantages of global expansion**
- Benefit from economies of scale.
- Access to cheaper resources.
- Access to new markets.
- Opportunity for managers to experience different cultures.
- Risk-reduction in different economies.
- Governments may offer incentives for foreign investment.

8. **Porter’s Diamond (competitive advantage of nations)**
- This model identifies the reason why nations excel in competition over others.
- It also identifies why specific industries cluster in specific areas in a country.
- It basically determines the competitive advantage of nations.
- It identifies the factors that cause some industries to succeed and not others.
- It can help assess factor conditions in a foreign country for expansion.
- Governments can use it to attract investment in specific industries.
Porter identified four factors in his diamond model:
- Factor conditions
- Demand conditions
- Strategy, structure and rivalry
- Related and supporting industry

He also identified two other influential factors:
- The role of government
- The role of chance events

Factor conditions
- Factor conditions mean the quality of supply factors.
- The factors that contribute to competitive advantage are not easy to duplicate.
- Generally, basic factors like unskilled labour are easily replicable.
- It is the advanced factors that help gain competitive advantage.
- These factors include specific expertise in human, physical, knowledge and capital resources.
Demand conditions

- Cultured domestic customers lead to the development of competitive advantage.
- Leads to the development of extension strategies for declining products to extend their life.
- For instance, sophisticated Japanese electrical customers help Japanese companies excel in unsophisticated markets.

Strategy, structure and rivalry

- This focuses on the competition element in the industry.
- The level and type of competition in the domestic industry can have a positive effect on companies.
- The stiffness of competition teaches companies how to better respond to competition.
- Government policy also influences the level of competition.

Related and supporting industry

- The presence of industries that support a specific business.
- A developed supporting industry helps develop the business.
- A developed supply industry also develops the customer business.

Other factors

- The role of government influences the development of national industries.
- The role of chance events can also help develop certain industries, e.g. wars lead to development in the ammunition industry.
- Extensive research is necessary before entering a foreign market.
- Organisations would prefer to expand into the foreign countries that are most favourable to them.
- Need to know the barriers to entering a foreign market.

Drawbacks of Porter’s Diamond

- Porter’s research for this model only included developed economies.
- Porter assumed incorrectly that domestic businesses cannot compete with foreign investment.
- Porter’s Diamond does not factor in the success of multinational corporations.
- Every business in a country does not achieve success, which throws into doubt the importance of the Diamond alone for success.
9. Chapter summary

PEST
- Political
- Economic
- Social
- Technological

Porter's five forces
- threat of new entrants
- threat of substitute products
- bargaining power of buyers
- bargaining power of suppliers
- rivalry among existing competitors

Strategic Analysis: External Environment
Chapter 4

Life cycle
- introduction
- growth
- maturity
- decline

Global markets
- enter foreign markets - why?
- risks
- benefits

Porter's diamond
- factor conditions
- demand conditions
- firm strategy, structure and rivalry
- related and supporting industries
- //government + chance//

Competitor analysis