Chapter 2

ANALYZING THE EXTERNAL ENVIRONMENT OF THE FIRM

After reading this chapter, you should have a good understanding of:

**LO 1** the elements that constitute a firm’s general environment and their impact on the firm’s strategies and performance.

**LO 2** how to define the competitive environment and delineate industry boundaries.

**LO 3** why environmental scanning, environmental monitoring, and collecting competitive intelligence are critical inputs to developing forecasts of the business environment.

**LO 4** why scenario planning is a useful technique for firms competing in industries characterized by unpredictability and change.

**LO 5** how trends and events in the general environment and forces in the competitive environment are interrelated and affect performance.

**LO 6** how forces in the competitive environment can affect profitability and how a firm can improve its competitive position by increasing its power vis-à-vis those forces.

**LO 7** the concept of strategic groups and their strategy and performance implications.
The Canadian forestry industry was once the envy of the world, which is not surprising since Canada boasts over 400 million hectares of forest and lies next to the world’s largest market for timber, processed lumber, and paper products—the United States. The industry is a major employer in rural communities, where hundreds of mills process locally harvested timber; it represents one of the largest customers of the country’s railroads, trucks, and ports; it is the third largest export to the United States besides energy and automotive products. Of course, lumber disputes between the two trading partners have been an ongoing issue of that relationship going back centuries. The eastern border between the two countries is the result of a series of lumber trade–triggered skirmishes. Nevertheless, Canadian firms have enjoyed a natural advantage and have benefited enormously from the relationship, in the process providing good paying jobs to Canadians in rural communities across the country and contributing a sizeable part to the gross domestic product (GDP).

Recently, however, over 10 percent of the industry’s plant capacity has been permanently shelved, operating facilities have reported historic lows in utilization, about 20 percent of workers have been laid off, and firms, one after another, have been posting substantial losses. Both government and the industry’s big players blame the slumping housing market in the United States for these results, and yet industry counterparts in Latin America, Asia, and Europe are thriving. According to an industry report, while Canadian companies achieved a 0.1 percent return on capital employed during 2007, the same ratio was a healthy 7.8 percent in Latin America, 7.3 percent in Asia, 7 percent in Europe, and 5.8 percent in South Africa. Even American firms achieved 5.5 percent returns in the same period. Both the federal and provincial governments have responded with subsidies in energy rates, subsidies to keep the mills open, and subsidies for the construction and maintenance of forest access roads, but little to push research and development or foster a global mindset. Moreover, whenever any firms hint of a possible merger, the governments demand employment protections and divestitures of assets, effectively hamstringing the firms from achieving necessary scale. Yet, or because of these attitudes, not a single Canadian firm is on the list of the top 20 lumber companies in the world.

Without a doubt, the recovery of the Canadian lumber industry depends heavily on the U.S. economy, but equally unquestionably, the industry has missed the transformation taking place across the globe. In Brazil, new mills are built with the newest and best technology, and knowledge and innovation are central to the international success of Swedish and Finnish players, who not only produce specialty wood and fine paper products but sell their technology and equipment worldwide. These regions have invested in developing new markets and have moved up the value chain, producing high-value-added products that are less susceptible to transportation costs and commodity prices.

**Case Study**

The industry, as well as government, missed some key trends. Rather than embracing the shift to new markets, the deployment of new production technologies, and the creation of new products, firms in the industry persisted with traditional methods of harvesting and operations because they had been the key to past success. They ignored the increasing demand for lumber and paper products coming from newer economies, such as China, as well as the rules of the global game. Provincial governments continued to tie stamping licences to individual mills with the requirement that all timber harvested had to be processed locally by the particular mill; the practice ensured local employment and a decisively small scale and under-utilization of capacity in the industry. Government and the industry as a whole were preoccupied with the latest round of the North American softwood lumber dispute. Without a doubt, this has been a very serious and expensive issue for the Canadian industry,
but has been diverting attention from global developments taking place in the sector. It has delayed necessary investments in new plants and equipment and, to a large degree, has fuelled the regional and short-term perspectives espoused within the sector. It has resulted in critical delays in the closing of unproductive facilities, has put aside necessary mergers to achieve scale and rationalization of production in larger and more efficient plants, and has caused delays in investment in technology and product development. The companies, overall, made numerous strategic errors as they continued to develop their products based on traditional principles, that is, those of the customers and technologies in the North American market, without tracking the changing consumer tastes and preferences around the world.

Because they were not willing to respond to changing trends, their actions lacked speed and decisiveness. As a result, they are now lagging in an industry that they once dominated. Entire communities in Quebec, Ontario, and British Columbia that had historically prospered from the forest industry, today lie devastated, with extremely high levels of unemployment and few alternatives as, one after another, sawmills close down indefinitely and people lose their jobs.

To be successful, managers must recognize both opportunities and threats in their firm’s external environment. They must be aware of what is going on outside their company. If they focus exclusively on the efficiency of internal operations, their firm may degenerate into the world’s most efficient producer of buggy whips or carbon paper. A firm’s strategy can easily stray away and get out of touch with the evolving realities of the marketplace. Management’s assumptions, premises, and beliefs can start diverging from or become inconsistent with the actual structure of the relevant industry, the competition, and the customers.

To understand the business environment of a particular firm, managers need to continuously analyze and stay abreast of both the general environment and the firm’s industry and competitive environment. The general environment consists of myriad elements that an organization finds outside its own boundaries and which have some bearing on its ability to exist and thrive. Many factors shape the organization’s general environment, and the interrelationships among those factors are typically beyond the control of the managers of any given organization. Factors such as government legislation, general economic trends, globalization, advances in technology, national cultural differences, the general level of education, and an aging population could potentially and critically affect the fortunes of a particular organization; yet, its managers are largely powerless in any significant attempt to influence them.

Within this broad general environment, firms typically compete with other firms in the same industry. Industry or a company’s competitive environment, is composed of a set of firms that produce similar products or services, sell to similar customers, and use similar methods of production. An industry is commonly viewed from the suppliers’ perspective and is defined as a collection of similar producers and firms that employ fairly similar production processes. The beer industry, for example, consists of all the firms that own and operate brewing facilities, whether large or small, with a national or local presence. Under this perspective, Molson, Labatt, Sleeman, Moosehead, and a host of microbrewers, such as Yukon, Big Rock, Great Western, Brascal, Brasserie McAuslan, Nelson, Creemore Springs, Fireweed, Fort Garry, Storm Brewing in Newfoundland, and Wellington constitute the beer industry in Canada. A manager defining the industry for a strategy analysis will look to the list of firms, their relative strategies, their product offerings, as well as the various markets and consumers served by those firms. Possible substitute products, such as wines and spirits, will also be considered.
However, such a definition of an industry might not be complete. What about SABMiller, the world’s second largest brewer, which sells beer in Canada under licence but does not own any brewing capacity? Is it a competitor? What about some strong imports, such as Corona and Heineken? They ship their products into Canada from far-off locations. What about global brewers, such as Anheuser-Bush InBev and Sapporo that own two of the largest Canadian brewers, Labatt and Sleeman, respectively? What about the forays of some of the Canadian firms overseas, most notably Molson’s merger with Coors or its acquisition of Kaiser in Brazil? Although questions about market share, market coverage, or competitive behaviour will clearly have to incorporate those additional players, they may have little relevance in discussions about suppliers, production capacity or capacity utilization, or domestic distribution and regulations.

An industry can also be viewed from the market’s perspective. Consumers seek to satisfy their needs through the use of products and services. An industry consists of all those producers whose products can satisfy similar consumer needs. Thus, an opera company, the symphony, various theatres, and a professional sports franchise all compete for the entertainment dollars of a city’s residents and could rightly belong in the same industry, even though their operations are drastically different. Similarly, fancy chocolates, good wines, and flowers are competing options for consumers looking to express gratitude for a dinner invitation.

Alternative definitions of an industry may arise from identical products offered by very different firms. Consider, for example, a firm that sources from China and supplies accessories for power tools, drill bits, and blades to retailers, such as Canadian Tire, Home Depot, and Rona. What is a meaningful definition of its industry? Does it consist of other producers of power tool accessories, such as Stanley or Black & Decker, which produce similar accessories in North America? Or does it consist of other wholesalers who source small parts and tools from China, Korea, or Vietnam? Should both types be included in the definition of the industry? How can one make comparisons? Understandably, the issues faced by each are drastically different though they depend on the same markets for their business. Consumers, furthermore, may not really know or care whether the accessories come from one place or another.

Time is another factor in defining the boundaries of an industry. When the time dimension of a specific issue under consideration is relatively short, direct competitors belong in the same industry, and firms that produce different products for different markets can safely be left out. But when the strategy analysis encompasses a longer timeline, the assumption of strategic distance is no longer safe. Distant firms can find themselves in direct competition in the long run. For example, foreign competitors can enter the market within a long enough time, and the adoption of new technology can allow firms to leapfrog the competition.

Technological developments also raise substantial issues about the boundaries of industries. Telecommunications used to be governed by the same federal agency, the Canadian Radio-Television Telecommunication Commission (CRTC), even though telephone providers were separated from television broadcasters and cable companies. The three industries unfolded very differently and faced unique competitive pressures. Today, convergence is the buzzword in the whole sector, and everybody accepts the direct competition among Bell Canada Enterprises (BCE), Rogers, Telus, and Shaw. Moreover, Apple with its iPhone, Research in Motion (RIM) with the BlackBerry, and Microsoft have entered the fray.

Gathering industry information and understanding the competitive dynamics among the different companies in the industry are keys to successful strategic management. The challenge for managers is to define the industry broadly enough to incorporate the relevant issues but not so broadly that their focus is rendered meaningless.
In their award-winning book *Competing for the Future*, Gary Hamel and C. K. Prahalad suggest that “every manager carries around in his or her head a set of biases, assumptions, and presuppositions about the structure of the relevant ‘industry,’ about how one makes money in the industry, about who the competition is and isn’t, about who the customers are and aren’t, and so on.” Environmental analysis requires managers to continually question these assumptions. Peter Drucker labelled these interrelated sets of assumptions the “theory of the business.”

A firm’s strategy may be good at one point in time, but it may go astray when management’s frame of reference gets out of touch with the realities of the actual business situation. This happens when management’s assumptions, premises, or beliefs are incorrect or when internal inconsistencies among them render the overall “theory of the business” invalid. The past may be instructive, but there are no guarantees that it will repeat itself in the future. As Warren Buffett, investor extraordinaire, colourfully notes, “Beware of past performance ‘proofs.’ If history books were the key to riches, the Forbes 400, the list of the world’s wealthiest people, would consist of librarians.”

**CREATING THE ENVIRONMENTALLY AWARE ORGANIZATION**

Managers use three important processes—scanning, monitoring, and gathering competitive intelligence—to enhance their environmental awareness, better understand the environment that surrounds them, and develop forecasts about the future. Exhibit 2.1 illustrates the relationship among these important activities. In addition to forecasts, when smart managers feel that the future is truly murky and they cannot confidently foresee what it may hold, they build scenarios—mental landscapes of how the world may unfold—and engage in scenario planning, which allows them to anticipate major future changes in the external environment. Finally, managers frequently organize their analysis of and structure their conclusions about their outlook of the environment using the SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis framework. We review each of these tools below.

**Scanning, Monitoring, Competitive Intelligence, Forecasting, and Scenario Analysis**

*Environmental Scanning* Environmental scanning involves surveillance of a firm’s external environment to predict future environmental changes and detect changes...
Successful environmental scanning alerts the organization to critical trends and events before the changes have developed a discernible pattern and before competitors recognize them.\textsuperscript{6,7,8}

Spotting key trends requires a combination of knowledge and familiarity with the business and the customer, as well as keeping an eye on what is happening around us. Such big-picture/small-picture view enables us to better identify the emerging trends as they take shape. Exhibit 2.2 offers some suggestions on how to spot hot trends; specifically, it suggests listening, paying attention, and following trends both online and in more traditional formats.

Companies frequently seek insights from studies conducted by outside experts in a particular industry. For example, drawing on a study of the global automobile industry conducted by A. T. Kearney, a large international consulting company, one could identify several “key issues”:\textsuperscript{9}

- **Globalization.** Although not a new trend, it has significantly intensified, with enormous opportunities opening up in Asia, central and Eastern Europe, and Latin America. Moreover, new manufacturers from China and India are making their presence felt beyond their local markets.

- **Time to Market.** A gap still exists between product development cycles in the United States and Europe compared with those in Japan. This gap persists even though Japanese companies have been moving operations to other countries.

- **Shifting Roles and Responsibilities.** Design responsibility, purchasing, even project management and systems engineering are shifting from the original equipment manufacturers to integrators and other suppliers.

All firms in the industry are affected by such developments, and executives are called to consider them in their strategic responses.

Strategy Spotlight 2.1 shows how Toronto’s Pearson Airport uses online media and crowdsourcing to help it keep abreast of trends and promising opportunities.

**Environmental Monitoring** Environmental monitoring tracks the evolution of environmental trends, sequences of events, or streams of activities. The trends may be recognized already under way.\textsuperscript{6} Successful environmental scanning alerts the organization to critical trends and events before the changes have developed a discernible pattern and before competitors recognize them.\textsuperscript{7,8}

Exhibit 2.2

<table>
<thead>
<tr>
<th>How to Spot New Trends</th>
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<tr>
<td><strong>Listen:</strong> Ask your customers questions about your products and services. Ask what they are looking for next. Find out what media they are watching and what they think of current events.</td>
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<td><strong>Pay attention:</strong> Read trade publications related to your industry to identify key issues. Watch industries that are always on the cutting edge, such as music, fashion and design, to discover emerging trends that may affect your business.</td>
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<td><strong>Follow trends online:</strong> Trend-monitoring Web sites, such as trendhunter.com and jwtintelligence.com, offer up trends du jour. Add them to your regular Web-surfing itinerary. Participate in chat rooms, and find out what people are talking about. Organize online or in-person focus groups to learn what people are thinking. You can also launch social media groups or chat rooms to gather direct feedback from your audience.</td>
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How Toronto’s Pearson Airport Enhances Its Environmental Awareness

Toronto’s Pearson Airport, the largest international airport in Canada, relies on over 1,000 carefully selected individuals who keep it aware of trends and promising opportunities associated with air travel. Considered a special but representative group of passengers who reflect the diverse constituencies of the airport, they allow management to penetrate the minds of thousands of people as they pass through the airport each day, either rushing to catch a flight or strolling through its facilities for a couple of hours waiting for the next flight. Over 30 million passengers and 400,000 flights take off and land at the airport each year, and having a better sense of these individuals’ behaviours as well as broader trends is critical to management in deciding on improvements, services, and capacity expansion.

The program, code named “Jennifer,” has connected with a select group of customers to obtain their feedback online, has been used to test new services to be offered at the airport, has showcased and assessed new retail and restaurant concepts using virtual images and interactive software, and has gathered thousands of ideas on how to improve the entire airport experience. “Jennifer” also frequently questions her “contacts” about their future travelling plans, changes in habits that could affect their use of the airport, and their outlook on flying. “Jennifer” is a personable but nonintrusive presence that communicates with passengers on a first-name basis through emails, e-messages, and tweets; the program encourages the passengers to share their thoughts and their opinions about the airport in general as well as specific aspects and solicits their creative ideas. “Jennifer” even allows its contacts to comment and assess each other’s ideas as they arise. Market testing is thus done even before these ideas take final shape. Admirably, Jennifer can accomplish all this without having to resort to point systems, freebies, or other potentially reliability-distorting incentives to gather valuable insights.

 Sources: Greater Toronto Airports Authority website and publications; participation in the Jennifer program.

Competitive Intelligence

Competitive intelligence (CI) helps firms better define and understand their industry as well as identify rivals’ strengths and weaknesses. It includes the intelligence gathering associated with the collection of data on competitors and the interpretation of such data for managerial decision making. Competitive intelligence helps a company avoid surprises by anticipating competitors’ moves and decreasing its own response time.

by the firm by accident or are brought to its attention through its environmental scanning or from outside the organization. Consider the automobile industry example above. Although environmental scanning may make the automobile industry executive aware of these trends, this is not sufficient. The ability to respond to those trends requires close monitoring, which involves closer ongoing scrutiny. For example, managers should closely monitor sales in Asia, Central and Eastern Europe, and Latin America. They should observe how fast Japanese companies and other competitors bring products to market compared with their own firm. What about escalating oil prices and their implications for consumer attitudes, let alone their wallets? Managers should also study trends with their own suppliers or integrators in purchasing, project management, and systems engineering. Monitoring enables firms to evaluate how dramatically environmental trends are changing the competitive landscape.

Other trends to monitor could be demographics and aging, as well as the percentage of GDP spent on health care (for a medical devices firm), shifts in insurance coverage and the balance between government dollars and privately covered expenses (for a pharmaceutical firm), new building permits (for an appliance manufacturer), or housing starts (for a furniture retailer).
Examples of competitive analysis are evident in daily newspapers and periodicals, such as *The Globe and Mail* (Report on Business), *The Wall Street Journal*, *BusinessWeek*, and *Fortune*. For example, banks continually track home loan, auto loan, and Guaranteed Investment Certificates (GIC) interest rates charged by competitors in a given geographic region. Major airlines change hundreds of fares daily in response to competitors’ tactics. Car manufacturers are keenly aware of announced cuts or increases in rivals’ production volumes, sales, and sales incentives (e.g., rebates and low interest rates on financing). They use this information to plan their own marketing, pricing, and production strategies. Exhibit 2.3 provides some insights into what CI is (and what it is not).

The Internet has dramatically accelerated the speed with which firms can find competitive intelligence. Creativity and effective information gathering skills are critical for meaningful intelligence. Specialist firms have sprouted to assist with the process. For example, in one case, a client wanted to determine the size, strength, and technical capabilities of a privately held company. Initially, it was difficult to get detailed information. Then one analyst used Deja News (www.dejanews.com), a unit of Google, to tap into some online discussion groups. The analyst’s research determined that the company had posted 14 job openings on one Usenet group. That posting was a road map to the competitor’s development strategy.

### Exhibit 2.3

What Competitive Intelligence Is and Is Not!

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<th>Competitive Intelligence Is …</th>
<th>Competitive Intelligence Is Not …</th>
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<td>1. <strong>information</strong> that has been analyzed to the point where it is possible to make an appropriate decision.</td>
<td>1. <strong>spying</strong>. Spying implies illegal or unethical activities. It rarely occurs because most corporations do not want to find themselves in court or upsetting shareholders.</td>
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<td>2. <strong>a tool</strong> to alert management early to both threats and opportunities.</td>
<td>2. <strong>a crystal ball</strong>. CI gives corporations good approximations of reality, short term and long term. It does not predict the future.</td>
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<tr>
<td>3. <strong>a means to deliver reasonable assessments</strong>. CI offers approximations of the market and the competition. It is not a peek at a rival’s financial books. Reasonable assessments are what modern entrepreneurs need and want on a regular basis.</td>
<td>3. <strong>database search</strong>. Databases offer just that—data. They do not analyze the data in any way. They certainly do not replace human beings, who make decisions by examining the data and applying their common sense, experience, and intuition.</td>
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<td>4. <strong>a way of life, a process</strong>. If a company uses CI the way it should be used, CI becomes everyone’s job—not just the strategic planning or marketing staff’s. It is a process by which critical information is available to those who need it.</td>
<td>4. <strong>a job for one smart person</strong>. A CEO may appoint one person as the CI ringmaster, but one person cannot do it all. At best, the ringmaster can keep management informed and ensure that others become trained to apply this tool within their business units.</td>
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At times, a firm’s aggressive efforts to gather competitive intelligence may lead to unethical or illegal behaviours. Strategy Spotlight 2.2 tells the story of two well-known rivals, who probably crossed the line in their efforts to gather competitive intelligence. Strategy Spotlight 2.3 provides an example of a company, United Technologies (UT), that has set clear guidelines to help prevent unethical behaviour.

A word of caution: Executives must be careful to avoid spending so much time and effort tracking the competitive actions of traditional competitors that they ignore new competitors. Further, broad changes and events in the larger environment may have a dramatic impact on a firm’s viability. Peter Drucker, whom many consider the father of modern management, wrote:

Increasingly, a winning strategy will require information about events and conditions outside the institution: noncustomers, technologies other than those currently used by the company and its present competitors, markets not currently served, and so on.

Consider the fall of the mighty Encyclopaedia Britannica, once the global leader of printed information in the English speaking world. Its demise was not caused by a
Ethical Guidelines on Competitive Intelligence: United Technologies

United Technologies (UT) is a $28-billion global conglomerate composed of world-leading businesses with rich histories of technological pioneering, such as Otis Elevator, Carrier Air Conditioning, and Sikorsky (helicopters). It was founded in 1853 and has an impressive history of technological accomplishments. UT built the first working helicopter, developed the first commercially available hydrogen cells, and designed complete life support systems for space shuttles. UT believes strongly in a robust code of ethics. In the last decade, it has clearly articulated its principles governing business conduct. These include an antitrust guide, an ethics guide when contracting with the U.S. government as well as foreign governments, a policy on accepting gifts from suppliers, and guidelines for the proper use of email. One such document is the Code of Ethics Guide on Competitive Intelligence. This encourages managers and workers to ask themselves the following five questions whenever they have ethical concerns:

1. Have I done anything that coerced somebody to share this information? Have I, for example, threatened a supplier by indicating that future business opportunities will be influenced by the receipt of information with respect to a competitor?

2. Am I in a place where I should not be? If, for example, I am a field representative with privileges to move around in a customer’s facility, have I gone outside the areas permitted? Have I misled anybody to gain access?

3. Is the contemplated technique for gathering information evasive? Does it involve sifting through trash or setting up an electronic “snooping” device directed at a competitor’s facility from across the street?

4. Have I misled somebody in a way that the person believed sharing information with me was required or would be protected by a confidentiality agreement? Have I, for example, called and misrepresented myself as a government official who was seeking some information for some official purpose?

5. Have I done something to evade or circumvent a system intended to secure or protect information?


Environmental Forecasting

Environmental scanning, monitoring, and competitive intelligence are important inputs for analyzing the external environment. However, they are of little use unless they provide raw material that is reliable enough to help managers...
make accurate forecasts. Environmental forecasting involves the development of plausible projections about the direction, scope, speed, and intensity of environmental change. Its purpose is to predict change. It asks: How long will it take a new technology to reach the marketplace? Will the present social concern about an issue result in new legislation? Are current lifestyle trends likely to continue?

Some forecasting issues are much more specific to a particular firm and the industry in which it competes. Since the late 1990s, Bombardier had been contemplating future trends in people’s travel patterns to help it decide whether to invest in a new-generation aircraft that can carry between 110 and 135 passengers. Eventually, it announced its plan for the new aircraft, but only five years after Embraer introduced its own version, which helped the Brazilian firm move into the third spot in global rankings and displace its Canadian rival. Bombardier is using the current high oil prices to emphasize the economics of its proposed design that uses state of the art materials and a completely redesigned engine to claim that the aircraft will be 20 percent more efficient than anything else available in the market and justify its late entry and belated response. Within the same industry, Europe’s Airbus bet its future on A380, a giant airliner that can carry up to 800 passengers and presumably ease congestion in some of the world’s busiest airports. Boeing maintains that the future lies in smaller planes, such as its upcoming 787, which can quickly move in and out of busy airports. Each company has bet billions of dollars on its own belief about how the future will turn out.

A danger of forecasting is that managers may view uncertainty as black and white and ignore important grey areas. Either they assume that the world is certain and open to precise predictions, or they assume it is uncertain and completely unpredictable. Underestimating uncertainty can lead to strategies that neither defend against looming threats nor take advantage of opportunities. In 1977, Kenneth H. Olsen, then president of Digital Equipment Corp., announced, “There is no reason for individuals to have a computer in their home,” and directed all his firm’s research efforts on mainframe computers and workstations. The explosion in the personal computer market was not easy to detect in 1977, but it was clearly within the range of possibilities that industry experts were discussing at the time. Similarly, there have been numerous underestimates of the growth potential of new telecommunication services. The electric telegraph was derided by Ralph Waldo Emerson, and the telephone had its sceptics. Similarly, “experts” could not imagine people sitting in front of these “boxes” hours at a time instead of listening to the radio. In turn, radio was expected to disappear soon after cassette and CD players were introduced. An “infamous” McKinsey study in the early 1980s predicted fewer than one million users of cellular phones in the United States by the year 2000.

At the other extreme, if managers assume the world is unpredictable, they may abandon the analytical rigour of their traditional planning process and base their strategic decisions on gut instinct. Such a “just do it” approach has led many executives to place uninformed bets on emerging products or markets that have resulted in record write-offs.

**Scenario Analysis** A more in-depth approach to forecasting involves scenario analysis. It draws on a range of disciplines and interests, among them economics, psychology, sociology, and demographics. It usually begins with a discussion of participants’ thoughts on ways in which societal trends, economics, politics, and technology may affect the issue under discussion. Consider Lego, for example. The popular Danish toy manufacturer has a strong position in its market for “construction toys.” However, what would happen if its market, broadly defined, should change dramatically? After all, Lego competes not only with producers of
similar products, such as Mega Bloks, Canada’s largest toy manufacturer. It competes on a much broader canvas for a share of children’s playtime. From this perspective, Lego products have numerous competitors, many of them computer based; still others have not yet been invented. Lego may end up with an increasing share of a narrow, shrinking market, much like IBM in the declining days of the mainframe computer. To avoid such a fate, managers must consider their future in a context wider than their present, traditional markets. They need to lay down guidelines for at least 10 years into the future to anticipate rapid changes. Scenarios represent one technique that can assist managers in coping with the uncertainty and unpredictability of today’s rapidly changing world, where competition can appear from anywhere at any time and where the rules of the game can change with little warning.

Scenario analysis is different from other tools for strategic planning, such as trend analysis or high and low forecasts. The origins of scenario planning lie in the military, which used it during World War II to effectively cope with multiple challenges, limited resources, and great unpredictability in the unfolding of the war.20 Strategy Spotlight 2.4 provides an example of scenario analysis at Shell Oil Company, one of the earliest adopters of this kind of analysis, which used it to prepare to cope with the uncertainty of extreme volatility in oil prices. Other practitioners of scenario planning include Levi Strauss, which uses it to consider potential impacts of everything from cotton deregulation to the unlikely occurrence of the total disappearance of cotton from this planet. Also, a German insurance company contemplated the fall of the Berlin Wall and made plans to expand in Central Europe. And in 1990, when Nelson Mandela was released from a South African prison, he met with a panel that helped him create scenarios to chart the country’s possible futures. Scenario planning helps by considering not trends or forecasts but how these could be upset by unpredictable events.

**SWOT Analysis**

One of the most widely used, if not basic, techniques for analyzing firm and industry conditions is the SWOT analysis. SWOT stands for Strengths, Weaknesses, Opportunities, and Threats. The SWOT analysis provides a framework for analyzing those four elements of a company’s internal and external environments. Managers rely on SWOT to stimulate self-reflection and group discussions about how to improve the firm and position it for success. They use it regularly to identify and evaluate the opportunities and threats in the business environment as well as the strengths and weaknesses of their firm’s internal environment. SWOT guides managers to develop a basic listing of conditions both inside and surrounding their firm.

The “strengths and weaknesses” portion of SWOT refers to the areas within the firm where it excels, where its traditional points of power, ability, and capacity lie (strengths), and, conversely, where there may be disadvantages and where it may be lacking relative to its competitors (weaknesses). Examples of strengths may be superior knowledge, strong brands, state-of-the-art facilities, unique access to certain markets, highly motivated workforce, extensive distribution networks, deep financial pockets, and strong leadership. In contrast, weaknesses can be found in difficulties in accessing raw materials, wounded brands, high financial leverage, and pending lawsuits. Strengths and weaknesses are addressed more extensively in Chapter 3, through our discussion of an organization’s value chain and the resource-based view of the firm.

Opportunities and threats are environmental conditions external to the firm. These could be factors in the general environment, such as improving economic conditions that
cause lower borrowing costs or an aging population that demands new services for leisure and convenience. Opportunities can arise from technological developments, such as the Internet and telecommunications, or advances in biotechnology. One can find opportunities almost everywhere, in identifying new market needs, new and better ways to respond to existing needs, new ways of delivering products and services, new applications of technology, easing regulatory conditions, industry consolidation, or technology convergence. Threats can mount from formidable competitors, new legislation, an aging population, shifts in the tastes and values of consumers, protectionism, terrorism, an oil crisis, increasing commodity prices, or a new technology that threatens to make the firm’s products obsolete.

Although opportunities and threats are rather subjective interpretations of what is unfolding in a firm’s external environment, and two informed individuals can easily come up with two different lists, it is important that managers systematically consider each area of their general and competitive environments for specific opportunities as well as for looming threats. It is also important not to cast the net too narrow. Strategists who rely on traditional definitions of their industry and competitive environment often focus their sights too narrowly on current customers, technologies, and competitors. Hence, they fail to notice important changes in the periphery of their environment—changes that may trigger the need to redefine industry boundaries and identify a whole new set of competitive relationships. It is also important not to focus too much on one moment in time. Strategy and competition unfold over time. As circumstances change, a static analysis cannot capture the dynamics of the competitive environment; managers risk missing the changing impact on their strategies and competitiveness.

Scenario Planning at Shell Oil Company

In the 1960s and 1970s, Shell combined analytical tools with information to create scenarios of possible outcomes. The result of the 1973 oil embargo was a sharp increase in crude oil prices, short supplies of gasoline for consumers, and a depressed world economy. However, Shell’s strategic planning, which included the use of scenarios, had strongly suggested that a more unstable environment was coming, with a shift of power from oil companies to oil producers. As a result of the precautionary actions it took, Shell was in a better position than most oil companies when the 1973 embargo occurred. Shell also uses scenario planning to plan major new oil field investments. This is because elements of risk can be identified and explored over a considerable period.

The Shell process of scenario planning involves the following stages:

1. Interviews with people both inside and outside the business, using an open-ended questioning technique to encourage full and frank answers.
2. Analysis of interviews by issue to build a “natural agenda” for further processing.
3. Synthesis of each agenda so as to draw out underlying areas of uncertainty or dispute and possible interrelationships among issues.
4. A small number of issues workshops to explore key issues to improve understanding and identify gaps for further research. These generate a wide range of options for strategy.
5. A scenario workshop to identify and build a small number of scenarios, which may occur in some 10 to 15 years’ time or even later.
6. A testing of strategy options against the scenarios to assess robustness (i.e., whether or not a given strategy is effective under more than one scenario).

Not all trends, opportunities, and threats apply equally to all companies within an industry, and one firm’s SWOT analysis is not applicable to another. Specific trends may benefit some companies but harm others. Consider, for example, the heightened awareness about health and fitness, which presents an opportunity to some companies (e.g., health clubs and diet-food producers), but represents a clear threat to others (e.g., tobacco firms and breweries).

It is also worth noting that SWOT analysis is not the unquestionable solution to strategic planning and should not be seen as an end in itself. It is a framework that allows a manager to classify issues and observations in a meaningful and useful way. It does, however, have its limitations. It is simply a starting point for discussion. By listing the firm’s attributes, managers identify the raw material needed to perform more in-depth strategic analysis. SWOT analysis cannot, however, yield environmental forecasts nor show managers how to achieve a competitive advantage. SWOT’s value lies in providing a systematic framework to initiate discussion among thoughtful managers who are contemplating the challenges and opportunities facing their firm.

### THE GENERAL ENVIRONMENT

The general environment is composed of factors that can have dramatic effects on a firm’s strategy and critically affect its performance. Yet, typically, a firm has little ability to predict the trends and events in the general environment and even less ability to control them. It is difficult to predict future political events, such as the ongoing Middle East unrest and tensions on the Korean peninsula. It is not easy to anticipate and be prepared for shocks, such as skyrocketing oil and other commodity prices, the SARS crisis, “mad cow” disease outbreak, terrorism, and others; nor is it easy to fathom their financial, social, and economic impacts. Who would have guessed the Internet’s impact on national and global economies as has occurred in the past decade or two? In the 1980s, the Internet was little more than a tool for academic researchers to exchange computer files. In less than 20 short years, dramatic innovations in information technology, along with many other factors, have helped keep inflation in check across the world by lowering the cost of doing business and bringing the world closer together.

We divide the general environment into six segments: (1) demographic/psychographic, (2) sociocultural, (3) political/legal, (4) technological, (5) economic, and (6) global. First, we discuss each segment and provide a summary of the segment and examples of how events and trends in each segment can impact industries. Then, we address relationships among the general environment segments and consider how similar trends and events can have varying impacts across industries. Exhibit 2.4 provides examples of key trends and events in each of the six segments of the general environment.

### The Demographic/Psychographic Segment

Demographics are the most easily understood and quantifiable elements of the general environment. They are at the root of many changes in society. Demographics include elements such as an aging population, rising or declining affluence, changes in ethnic composition, geographic distribution of the population, and disparities in income level. Psychographics reflect the various attitudes and interests among individuals and complement the demographic characteristics of the population. Psychographics capture the
Exhibit 2.4
General Environment: Key Trends and Events

Demographic/Psychographic
- Aging population
- Rising affluence
- Changes in ethnic composition
- Geographic distribution of population
- Greater disparities in income levels
- Education
- Diminishing sense of loyalty to corporations among urban professionals

Sociocultural
- More women in the workforce
- Increase in the number of temporary workers
- Greater concern for fitness
- Greater concern for the environment
- Postponement of family formation

Political/Legal
- Protection of cultural industries (e.g., CRTC)
- Aboriginal land claim settlements
- Deregulation of utility and other industries
- Increases in provincially mandated minimum wages
- Taxation at provincial and federal levels
- Legislation on corporate governance reforms in bookkeeping, stock options, etc.

Technological
- Genetic engineering
- Emergence of Internet technology
- Computer-aided design/computer-aided manufacturing (CAD/CAM) systems
- Research in synthetic and exotic materials
- Pollution/global warming
- Miniaturization of computing technologies
- Wireless communications
- Nanotechnology

Economic
- Interest rates
- Unemployment
- Consumer Price Index
- Trends in GDP
- Changes in stock market valuations

Global
- Increasing global trade
- Currency exchange rates
differences among individuals who may belong to a particular group, such as urban professionals, college students, and stay-at-home fathers, but vary widely in their perceptions, priorities, and the ways they interpret and react to external events.

The impact of a demographic trend, like trends in all segments of the general environment, varies across industries. The aging of the Canadian population might have a positive effect on the real estate and consumer industries but a negative impact on manufacturers of diapers and baby food. Rising levels of affluence in many developed countries bode well for such industries as brokerage services and upscale pets and supplies. However, these same trends may have an adverse effect on fast-food chains because people can afford and prefer to dine at higher-priced restaurants. Fast-food restaurants depend on minimum-wage employees for efficient operation, but the competition for labour intensifies as more attractive employment opportunities become prevalent, thus threatening the employment base for restaurants. Let us look at the details of some of these trends.

The aging of the population in Canada and in other developed countries has important implications. The aging “baby boomers” (those born between 1945 and 1964), who control an estimated 80 percent of the wealth in Canada, will be reaching retirement in just a few years. By 2025, nearly one-fifth of Canadians will be over 65 years old. This may be good news for drugstores, which see older patients seven times more often than younger ones. The life insurance industry benefits from increasing life expectancies, but hospitals find their budgets strained by the more expensive and more intensive health-related needs of the aging population.

Another demographic trend is the shift in what constitutes a family. Households are now smaller. In 2001, Canada had as many one-person households (2.97 million) as households of four or more people (2.94 million). Two-person households now account for one-third of all households. Smaller family sizes are due, in part, to the decreasing fertility rates, but there has also been an increase in the number of childless couples and “empty nesters” (parents whose children have moved out). At the same time, more young adults, aged 20 to 29 years, are continuing to live with their parents. In 2001, 41 percent of the 3.8 million young adults lived with their parents. Those of the baby-boom echo generation—born during the 1980s to the baby boomers themselves—are repeating the buying behaviours of their parents as they go through college, rent apartments, and form families of their own.

### The Sociocultural Segment

Sociocultural forces influence the values, beliefs, and lifestyles of a society. Examples include a higher percentage of women in the workforce, more dual-income families, increases in the number of temporary workers, greater concern for healthy diets and physical fitness, greater interest in the environment, and more and more people choosing to
postpone having children. Such forces enhance sales of products and services in many industries but depress sales in others. The increased numbers of women in the workforce and dual-income families have, in turn, increased the need for business clothing merchandise but decreased the demand for baking product staples. A greater concern for health and fitness has helped industries that manufacture exercise equipment and healthful foods but has negatively impacted industries that produce snack foods and candy.

Sociocultural norms impact attitudes about entrepreneurship and the start-up activities of firms. Canada, together with the United States and Israel, scored the highest among respondents in terms of their propensity to start a business and the general view that starting a new business was a “respected occupation.” Such attitudes have traditionally served countries well in encouraging individuals to take risks and to venture on their own, both of which bode well for the economic prosperity of the country.

The trend toward higher educational attainment among women has led to the increased participation of women in upper management positions. Statistics show that more women have college degrees compared with men. Based on the figures of a recent graduating class, women with bachelor’s degrees outnumber their male counterparts by 27 percent. For the class of 2006–2007, the gap surged to 38 percent. Additionally, throughout the 1990s, the number of women earning MBAs increased by 29 percent compared with only 15 percent for men. Given these educational attainments, it is hardly surprising that companies owned by women have been one of the key drivers of the economy. Canada boasts one of the highest rates of female employers and persons heading their own business at over 41 percent, compared with 39 percent in the United States and fewer than 30 percent in most of Europe.

The Political/Legal Segment

Political processes and legislation define the regulations that industries must comply with. Key elements of the political/legal arena include environmental regulation, occupational health and safety legislation, immigration policies, deregulation of utilities and other industries, and increases in provincially mandated minimum wages.

Government legislation has a significant impact on corporations. The U.S. Congress passed the Sarbanes–Oxley Act in 2002, and Canada followed soon with similar provisions, which greatly increased the accountability of auditors, executives, members of the board of directors, and corporate lawyers. Those provisions were introduced in response to the widespread perception that existing governance mechanisms had failed to protect the interests of shareholders, employees, and creditors. They were brought about by the embarrassing revelations and criminal activities associated with executives within Enron, Tyco, WorldCom, and Hollinger International. They have significant ramifications for all public and private corporations on both sides of the border as well as for numerous European and Asian companies that trade and have transactions with the North American financial markets.

As with many factors in the general environment, changes that benefit one industry may adversely affect others. Following the terrorist attacks of September 11, 2001, and the precipitous drop in air travel, the U.S. government announced financial assistance to the ailing airline industry to the tune of $5 billion cash and a further $10 billion in loan guarantees. Of course, the hotel and hospitality industries demanded similar assistance but received nothing. Opponents have argued that such schemes only enrich the shareholders of airline stocks at the expense of taxpayers. Related arguments have been raised in Canada with regard to financial assistance that has frequently been extended to Bombardier Inc. to enable it to continue assembling planes in Quebec and Ontario. In fact, in the last
few years, the government of Quebec has extended loan guarantees exceeding $2.3 billion to Bombardier in an effort to retain the high-paying jobs in the province.

Since Confederation, subsequent Canadian governments have adopted industrial policies that have been both interventionist and protectionist.29 As a result, every facet of the Canadian economy has been operating within a framework of thousands of regulations, and more than 700 Crown corporations have been involved in everything from selling liquor to producing nuclear reactors. Although the rationale has always been a desire to maintain economic and cultural independence from the United States, critics argue that such regulations have also been responsible for the relative underperformance of the Canadian economy in the latter part of the twentieth century compared with most of the other industrialized nations.

The Technological Segment

Developments in technology lead to new products and services and improve how they are produced and delivered to the end user. Innovations can create entirely new industries and alter the boundaries of existing industries.30 Notable technological developments and trends are genetic engineering, nanotechnology, and research in artificial and exotic materials.

Likely the most significant technological development of our time is the combination of information technology (IT) and the Internet. The Internet has reduced the cost of getting information and increased its availability in impressive ways. For example, Fidelity Investments has found that it costs $15 to handle a transaction over the phone but less than a cent to perform that same transaction on the Web.31 Airlines have saved billions of dollars by diverting passengers away from commissioned travel agents and their own telephone operators, which traditionally cost in excess of 5 percent of the price of a ticket; purchases on the airlines’ own Web sites cost pennies and, as an added benefit, decrease errors and increase loyalty among their customers.

However, there are some downsides to technology development. In addition to ethical issues raised by advances in biotechnology, there are threats to the earth’s environment associated with the emission of greenhouse gases, pollution, and global warming. To combat such problems, some firms in the petroleum industry are taking creative and proactive steps. BP Amoco, for example, plans to decrease its greenhouse gas emissions by giving each of its 150 business units a quota of emission permits and encouraging the units to trade among themselves. If a unit cuts emissions and has leftover permits, it can sell them to other units that are having difficulty meeting their goals.32

The Economic Segment

The economy affects all industries, from suppliers of raw materials to manufacturers of finished goods and services, as well as all organizations in the service, wholesale, retail, government, and non-profit sectors. Key economic indicators include interest rates, unemployment rates, the consumer price index, the GDP, and net disposable income. Interest rate increases have a negative impact on the residential home construction industry but a negligible (or neutral) effect on industries that produce essential consumer products such as prescription drugs or common grocery items.

Other economic indicators are associated with equity markets. Perhaps the most watched is the Dow Jones Industrial Average (DJIA), which is composed of 30 large industrial firms. When stock market indexes increase, consumers’ confidence and spending increase, and there is often an increased demand for luxury items, such as jewellery
and automobiles. But when stock valuations decrease, demand for these items shrinks. Recent Toronto and Calgary real estate market highs are attributed to the relative health of the commodities market worldwide.

The Global Segment

More and more firms have been expanding their operations and market reach beyond the borders of their “home” countries. Globalization provides opportunities to reach much larger potential markets as well as access a broader base of factors of production, such as raw materials, labour, skilled managers, and technical professionals.

Examples of important elements in the global segment include exchange rates, global trade, the fast-growing economies of China and India, trade agreements among regional blocs (e.g., North American Free Trade Agreement [NAFTA], European Union [EU], Association of Southeast Asian Nations [ASEAN]), and the General Agreement on Tariffs and Trade (GATT). Increases in trade across national boundaries provide benefits to the cargo and shipping industries but have a minimal impact on service industries, such as bookkeeping and medical services. The emergence of China as an economic power has benefited many industries and sectors, including steel, construction, and computers, as well as consumer goods. Nonetheless, it has had a negative impact on the clothing sector in North America and has posed serious challenges to many manufacturers.

Few industries are as global as the automobile industry. Consider just a few examples of how some of the key players expanded their reach into Latin America during the 1990s. Fiat built a new plant in Argentina; Volkswagen retooled a plant in Mexico to launch the new Beetle; DaimlerChrysler built a new plant as a joint venture with BMW to produce engines in Brazil; and General Motors built a new car factory in Brazil. Suppliers to the industry have followed suit. Magna and Dofasco have built facilities in the region to supply components on a just-in-time basis to those plants. Why the interest in this region? In addition to the region’s low wage rates and declining trade barriers, its population of 400 million is very attractive. But the real bonus lies in the 9-to-1 people-to-cars ratio in the region compared with a 2-to-1 ratio in developed countries. With this region’s growth expected to be in the 3- to 4-percent range in the first part of the twenty-first century, sales should increase at a healthy rate.

Similarly, consider the extent of globalization in the Norwegian shipping industry. Despite a small population of only 4.5 million, Norway developed the world’s third largest merchant fleet. And as the world’s second largest oil exporter, it has the vessels and equipment needed to service oil fields off its storm-prone coasts. When the warship *USS Cole* was severely damaged by terrorists on October 12, 2000, it was returned to the United States from Yemen aboard a giant Norwegian-owned transport ship, the *Blue Marlin*. Frederik Steenbuch, manager of Oslo-based Offshore Heavy Transport, which owns the *Blue Marlin*, stated: “This has nothing to do with Norway. It is purely international. The Blue Marlin was built in Taiwan, flies a Panamanian flag, and has a crew from Latvia. The key machinery on board was built in Korea under a Danish license.”

Relationships among the Elements of the General Environment

In our discussion of the general environment, we see many relationships among the various elements. For example, two demographic trends—the aging of the population and regional population shifts—have important implications for the economic segment
Another example is the emergence of IT as a means to increase the rate of productivity gains across many developed countries. Such use of IT results in lower inflation (an important element of the economic segment) and helps offset costs associated with higher labour rates.

The effects of a trend or event in the general environment vary across industries. Commodity price increases, especially for oil and gas, have boosted the economies of Alberta, Saskatchewan, and Newfoundland and have increased the value of the Canadian dollar by some 50 percent over the last few years. In turn, this has had devastating effects on the manufacturing sector in Ontario and Quebec whose exports to the United States have been battered by the increasing value of the loonie. The housing and financial crises in the United States have further crippled Canadian industries that traditionally rely on a healthy American market. Governmental legislation that permits the importation of prescription drugs from Canada into the United States is a very positive development for Canadian drugstores but a very negative event for drug manufacturers in the United States. Exhibit 2.5 provides other examples of how the impact of trends or events in the general environment can vary across industries.

THE COMPETITIVE ENVIRONMENT

In addition to the general environment, managers must consider the competitive environment (also sometimes referred to as the task or industry environment). The nature of competition in an industry as well as the profitability of a particular firm are more directly influenced by developments in the competitive environment. The competitive environment consists of many factors that are predominantly relevant to a firm’s strategy. These include existing or potential competitors, customers, and suppliers. Potential competitors may include a supplier considering forward integration, such as an automobile manufacturer acquiring a rental car company, or a firm in an entirely new industry introducing a similar product that uses a more efficient technology.

In the following sections, we discuss key concepts and analytical techniques that managers should use to assess their competitive environments. First, we examine Michael Porter’s five-forces model that illustrates how these forces can be used to explain individual firms’ profitability in an industry. Then, we address the concept of strategic groups, which demonstrates that even within an industry, it is often useful to group firms on the basis of similarities in their strategies. Firms within a strategic group tend to react similarly to external events, and competition tends to be more intense among firms within a strategic group than between strategic groups.

Porter’s Five-Forces Model of Industry Competition

The “five forces” model developed by Michael E. Porter has been the most commonly used analytical tool for examining the competitive environment. It describes the competitive environment in terms of five basic competitive forces:

1. The threat of new entrants
2. The bargaining power of buyers
3. The bargaining power of suppliers
### Exhibit 2.5
**The Impact of General Environmental Trends and Events on Various Industries**

<table>
<thead>
<tr>
<th>Segment/Trends and Events</th>
<th>Industry</th>
<th>Positive</th>
<th>Neutral</th>
<th>Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Demographic/Psychographic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aging population</td>
<td>Health care</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Baby products</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Rising affluence</td>
<td>Brokerage services</td>
<td>✓</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Fast foods</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Upscale pets and supplies</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Sociocultural</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>More women in the workforce</td>
<td>Clothing</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Baking products (staples)</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Greater concern for health and fitness</td>
<td>Home exercise equipment</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Meat products</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td><strong>Political/Legal</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environmental legislation</td>
<td>Heavy manufacturing</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Environmental consulting</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Plastics, chemicals</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Technological</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Genetic engineering</td>
<td>Pharmaceutical</td>
<td>✓</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Publishing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pollution/global warming</td>
<td>Engineering services</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Petroleum</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Economic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate increases</td>
<td>Residential construction</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Most common grocery products</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Global</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increasing global trade</td>
<td>Shipping</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Personal service</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emergence of China as an economic power</td>
<td>Soft drinks</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Defence</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4. The threat of substitute products and services  
5. The intensity of the rivalry among competitors in an industry

Each of these forces affects a firm’s ability to compete in a given market. Together, they determine the profit potential for a particular industry. The model is shown in Exhibit 2.6. Managers should be familiar with the five-forces model for several reasons.
Exhibit 2.6
Porter’s Five-Forces Model of Industry Competition

It helps them assess the overall attractiveness of an industry and decide whether their firm should remain in or exit that industry. It provides the rationale for increasing or decreasing resource commitments. The model helps assess how to improve a firm’s competitive position with regard to each of the five forces. For example, managers can use insights provided by the five-forces model to create higher entry barriers that discourage new rivals from competing with their firm. Or they may develop strong relationships with their distribution channels to better balance the bargaining power of their buyers.

The Threat of New Entrants  The threat of new entrants refers to the possibility that the profits of established firms in the industry may be eroded by new competitors. The extent of the threat depends on existing barriers to entry and the combined reactions from existing competitors. If entry barriers are high and/or the newcomer can anticipate a sharp retaliation from established competitors, the threat of entry is low. These circumstances discourage new competitors. There are six major sources of entry barriers:

- Economies of scale. Economies of scale refer to spreading the costs of production and other business activities over a large number of units produced. The per-unit cost of a product typically decreases as the absolute volume produced within a period increases. Larger facilities, automation, fixed overhead costs, and advertising expenses can be some of the typical sources of economies of scale for a traditional manufacturer. For example, research and development costs, commercialization expenses, and legal and regulatory compliance give significant rise to economies of scale in the pharmaceutical industry. The presence of such economies of scale in an industry deters entry by forcing the firm contemplating entry to come in on a large scale and risk strong reaction from existing firms or come in on a small scale and accept a cost disadvantage.
• **Product differentiation.** When existing competitors have strong brand identification and customer loyalty, differentiation creates a barrier to entry by forcing entrants to spend heavily to overcome existing customer loyalties. Building a brand requires enormous investment, takes time, and is of course fraught with risk.

• **Capital requirements.** The need to invest large financial resources to compete creates a barrier to entry, especially if the capital is required for risky or unrecoverable upfront advertising or research and development (R&D).

• **Switching costs.** A barrier to entry is created by the existence of one-time costs that the buyer faces when switching from one supplier’s product or service to another. Specialized equipment, non-standardized technologies, and unique inputs to a specific production process are some of the elements that generate switching costs and make it harder for customers to move away from an established firm to a new entrant.

• **Access to distribution channels.** The new entrant’s need to secure distribution for its product can create a barrier to entry. Exclusive agreements, restrictive practices, and franchise networks provide preferential access to an incumbent and preclude newcomers from establishing a foothold in a market.

• **Cost disadvantages independent of scale.** Some existing competitors may have advantages that are independent of size or economies of scale. These derive from:
  - Proprietary product
  - Favourable access to raw materials
  - Government subsidies
  - Favourable government policies

In an industry where few, or none, of these entry barriers are present, the threat of new entry is high. If a new firm can launch its business with little capital investment or can operate efficiently despite its small scale of operation, it is likely to be a serious threat, as new competitors can easily erode the profits of established firms. Industries such as dry cleaning, craft brewing, consulting, and much of retailing present few barriers and experience a constant entry and exit of players as firms can set up operations very easily and compete locally without much regard for global brands or large scale.

**The Bargaining Power of Buyers** Buyers threaten an industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other. These actions erode industry profitability. The power of each large buyer or buyer group depends on the attributes of the market situation and the importance of that group’s purchases to the industry’s overall business. Loblaw’s President’s Choice line of products demonstrates how a buyer can exert power over its suppliers by creating conditions to its advantage. Since the President’s Choice brand belongs to Loblaw, the producers have little influence on product design, features, or placement, and they must compete on price to attract the business from the powerful supermarket chain. Margins have decreased across the board among major producers in the food industry since Loblaw introduced its private label. Things deteriorated further for producers as soon as the success of Loblaw was followed by many other food retailers’ own private labels. Similarly, Wal-Mart absorbs 30 percent of Procter & Gamble’s global production and critically affects the performance of one of the world’s largest consumer goods corporations. A buyer is powerful under the following conditions:

• **It purchases large volumes relative to a seller’s total sales.** If a large percentage of a supplier’s sales are purchased by a single buyer, the importance of the buyer’s business
to the supplier increases. Large-volume buyers, particularly, are powerful in industries with high fixed costs (e.g., automobile manufacturers to the steel industry).

- **The products it purchases from the industry are standard or undifferentiated.** Confident that they can always find alternative suppliers, buyers play one company against the other, as in commodity grain products.

- **The buyer faces few switching costs.** Switching costs lock the buyer to particular sellers. Specialized components force buyers to deal with specific suppliers and largely accept their terms. Conversely, when buyers can easily switch between suppliers for their needs, they can play one supplier against another. The buyer’s power is further enhanced if the seller faces high switching costs—if, for example, it has to commit substantial resources upfront for equipment or product design in order to earn the buyer’s business.

- **It earns low profits.** Low profits create incentives to lower purchasing costs. However, highly profitable buyers are generally less price sensitive.

- **The buyers pose a credible threat of backward integration.** If buyers are either partially integrated or pose a credible threat of backward integration, they are typically able to secure concessions.

- **The industry’s product is unimportant to the quality of the buyer’s products or services.** When the quality of the buyer’s products is not affected by the industry’s product, the buyer is more indifferent to the input’s features and concentrates, instead, on negotiating the lowest price.

At times, a firm or set of firms in an industry may increase its buyer power by using the services of a third party. FreeMarkets Online is one such third party. Pittsburgh-based FreeMarkets has developed software that enables large industrial buyers to organize online auctions for qualified suppliers of semi-standard parts, such as fabricated components, packaging materials, metal stampings, and services. By aggregating buyers, FreeMarkets increases the buyers’ bargaining power. The results are impressive. In its first 48 auctions, most participating companies saved over 15 percent; some saved as much as 50 percent.

**The Bargaining Power of Suppliers** Suppliers can exert bargaining power over participants in an industry by threatening to raise prices, alter the terms of supply, or even lower the number of features and reduce the quality of goods and services they provide to the industry. Powerful suppliers can squeeze the profitability of firms in an industry to the point of taking away all the profits. The factors that make suppliers powerful tend to be mirror opposites of those that make buyers powerful. A supplier will be powerful in the following circumstances:

- **The supplier industry is dominated by a few companies and is more concentrated (few firms dominate the industry) than the industry it sells to.** Suppliers selling to fragmented industries exert influence over prices, quality, and terms.

- **The industry is not an important customer of the supplier.** When suppliers sell to several industries and a particular industry does not represent a significant fraction of their sales, suppliers are able to exert power.

- **The supplier’s product is an important input to the buyer’s business.** When such inputs are important to the success of the buyer’s manufacturing process or product quality, the bargaining power of suppliers is high.

- **The supplier’s products are differentiated, or it has built up switching costs for the buyer.** Differentiation or switching costs facing the buyers cut off their options to play...
one supplier against another. When buyers are unable to substitute among different inputs, their suppliers can exert substantial power in determining prices and terms. (Conversely, even large suppliers can be affected if they have to compete with substitutes.)

- **The supplier group poses a credible threat of forward integration.** This provides a check against the industry’s ability to improve the terms by which it purchases.

When considering supplier power, we typically focus on companies that supply raw materials, equipment, machinery, and associated services. But the supply of labour is also an important input to businesses, and labour’s power varies over time and across occupations and industries. As we enter the twenty-first century, the outlook is not very good for semi-skilled and unskilled labourers who face numerous substitutes, most notably, technology. Correspondingly, their wages have barely kept up with inflation. Immigration, de-unionization, and globalization have also diminished the relative bargaining power of those sectors of the labour market. In contrast, workers with the right skills and jobs have enjoyed the spoils of the New Economy and will likely continue to do so in the foreseeable future. Knowledge workers with specialized training and expertise are highly desirable and can command high compensation for their contributions; few viable substitutes currently exist to threaten their clout in the labour market.

**The Threat of Substitute Products and Services** All firms within an industry compete with other industries producing substitute products and services. Substitutes limit the potential returns of an industry by placing a ceiling on the prices that firms in that industry can charge. The more attractive the price-to-performance ratio of substitute products, the tighter is the lid on an industry’s profits.

Identifying substitute products involves searching for other products or services that can perform the same function as the industry’s offerings or satisfy the same needs of its customers. Flowers, greeting cards, and a box of chocolates have few physical characteristics in common, but they are easy substitutes in the eyes of well-wishing consumers. Identifying substitute products is not always easy; it is a subtle task that can lead a manager into businesses seemingly far removed from the industry. For example, the airline industry might not consider video camera technology much of a threat. But as digital technology has improved and wireless and other forms of telecommunication have become more efficient, teleconferencing has become a viable substitute for business travel for many executives. Strategy Spotlight 2.5 describes IBM’s uses of teleconferencing as an alternative to business travel. Similarly, Hewlett-Packard Company (HP) with some 320,000 employees and offices worldwide uses technology to coordinate virtual teams involved in a multitude of projects and has installed, in most of its locations, virtual conference rooms that can instantly bring people together to a meeting, without anyone ever having to step into an airport. The Halo system uses high-definition cameras and monitors to enable participants to see each other in life-size images. They can speak in real time while sharing documents, video and slide presentations. More importantly, HP has partnered with the Marriott Hotels chain to build facilities in multiple locations and make these services available to corporate customers around the world. While Marriott may get some of the old business travel dollars that are going to substitute products, the airlines are certainly left out in the cold.

**The Intensity of Rivalry among Competitors in an Industry** Firms use certain tactics, such as price competition, advertising battles, product introductions, and increased customer service or warranties, to win over customers and build their businesses. Some
Forms of competition, such as price competition, are typically quite destabilizing and are likely to erode the average level of profitability in an industry. Rivals easily match price cuts, an action that lowers profits for all firms. In contrast, advertising battles expand overall demand or enhance the level of product differentiation for the benefit of all firms in the industry. Rivalry, of course, differs across industries. In some instances, it is characterized as being warlike, bitter, or cut-throat, whereas in other industries it is described as being polite and gentlemanly. Intense rivalry is the result of several interacting factors, including the following:

- **Numerous or equally balanced competitors.** When there are many firms in an industry, the likelihood of mavericks is great. Some firms believe they can make moves without being noticed. Even when there are relatively few firms, and they are nearly equal in size and resources, instability results from fighting among companies that have the resources for sustained and vigorous retaliation.

- **Slow industry growth.** Slow industry growth turns competition into a fight for market share since firms seeking to expand their sales have to earn those new sales away from their competitors.

- **High fixed costs.** High fixed costs create strong pressures for all firms to increase capacity. Excess capacity often leads to escalating price cutting.

- **Lack of differentiation or switching costs.** Where the product or service is perceived as a commodity or near commodity, the buyer’s choice is typically based on price, service, and well-defined features, resulting in pressures from intense price and service competition. Lack of switching costs has the same effect, as competitors can easily replace each other’s product offerings.

- **Capacity augmented in large increments.** Where economies of scale require that capacity be added in large increments, capacity additions can be very disruptive to the industry supply–demand balance.

- **High exit barriers.** Exit barriers are economic, strategic, and emotional factors that keep firms competing, even though they may be earning low or negative returns on their investments. Some exit barriers take the form of specialized assets, fixed costs of exit, strategic interrelationships (e.g., relationships between the business units and others within a company in terms of image, marketing, shared facilities, and so on), emotional barriers, and government and social pressures (e.g., governmental discouragement of exit because of concern about job losses).

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**Substituting Business Travel with Technology: IBM**

Teleconferencing can save both time and money, as IBM found out with its “Manager Jam” idea. With over 350,000 employees, including 30,000 managers scattered around six continents, IBM is one of the world’s largest businesses. The shift to an increasingly mobile workplace means many managers supervise employees they rarely see face-to-face. To enhance coordination, Samuel Palmisano, IBM’s CEO, launched a program exploring the role of the manager in the twenty-first century. Manager Jam, as the project was nicknamed, was a 48-hour real-time Web event, in which managers from 50 different countries swapped ideas and strategies for dealing with problems shared by all of them, regardless of geography. Some 8,100 managers logged on to the company’s intranet to participate in the discussion forums—without having to leave their offices for a single moment.

Distractive Rivalry in the Canadian Skies

In 2005, the Canadian domestic airline industry was in a state of flux. Air Canada had just come out of a bankruptcy reorganization that effectively wiped out all shareholders’ investments in the company. When the reorganization was approved, Air Canada’s shares were charitably valued at $0.02. After the reorganization, the original bondholders of its debt became the owners of its parent, ACE Aviation Holdings. Air Canada had been able to shed a substantial portion of its debt burden and was in a better position to face the high fuel costs plaguing the industry and to handle heavy labour costs—the legacy of its prosperous past. Air Canada had come out with all of its route network and fleet intact. It still operated extensively cross-border, to the Caribbean, Mexico, Central America, as well as to the five main European capitals and, increasingly to Asia.

Yet, the big competitive battle was still within Canada’s borders. Its major competitor, WestJet of Calgary, with a fleet of very efficient workhorses, the Boeing 737s, was flying point to point within Canada and a limited number of routes to the United States. The competition was intense, even though Air Canada held 62 percent of the domestic market and WestJet 28 percent. Two smaller players, Jetsgo of Montreal and CanJet Airlines of Halifax, had 8 and 2 percent, respectively. The presence of Jetsgo seemed to be clouding the competitive dynamics. Jetsgo was fighting for its life with load factors that industry analysts speculated were below break-even. It was continuously underpricing the two larger carriers in an effort to attract new customers and was making headlines with “One Dollar” fares. CanJet followed suit, reducing fares for all overlapping routes. Although these two smaller airlines represented a very small slice of the market, they were forcing lower ticket prices on everybody.

To complicate matters further, Fidelity Investments, the largest mutual fund company in the United States, owned shares, through its various holdings, in Air Canada and WestJet, and it had also invested in Jetsgo. Analysts had been questioning the motives of Fidelity and had estimated that the existing state of affairs primarily hurt WestJet shares. If Jetsgo were to disappear, the big beneficiaries would not be the flying public or the employees but, rather, WestJet owners whose shares would appreciate by some 40 percent. A rational, wealth-maximizing shareholder would be expected to dump Jetsgo and watch his or her holdings in WestJet appreciate overnight. The rivalry among competitors in the domestic airline industry was extremely intense, and the competitive avenues readily expanded beyond the traditional dimensions.

As a postscript, Jetsgo, indeed, filed for bankruptcy in March 2005. Overnight, ACE and WestJet shares went up by 15 and 50 percent, respectively. Consumers complained that within a day or so, fares also increased by 10 to 20 percent on various domestic routes, although both airlines fervently denied that specific increases had anything to do with the disappearance of a nuisance competitor.

Rivalry between firms is often based solely on price, but it can involve other factors. Strategy Spotlight 2.6 discusses the intense rivalry among Canada’s airlines and the many elements resulting in rather distractive competition, as the players had difficulty understanding each other’s competitive moves.

How the Internet and Digital Technologies Are Affecting the Five Competitive Forces The Internet and other digital technologies are having a significant impact on nearly every industry. These technologies have fundamentally changed the ways businesses interact with each other and with customers. In most cases, these changes have affected industry forces in ways that have created many new strategic challenges. For example, the threat of new entrants has increased because digital and Internet-based technologies lower barriers to entry. Businesses that reach customers primarily through the Internet may enjoy savings on traditional expenses, such as office and retail space rent, sales-force salaries, printing, and postage. This encourages more entrants who, because of the lower start-up expenses, see an opportunity to capture market share by offering a product or performing a service more efficiently than existing competitors do. Similarly, competitors from other countries and distant locations can use their presence on the Internet to compete with local businesses without the need to establish a physical presence and incur the costs of establishing a local office. Young firms can provide services that cater to a
niche and do so more effectively by attracting customers from a much broader geographic coverage, who are still part of that narrow niche and who perceive the superior value of the specialized service.

Buyers’ bargaining power may increase as consumers can access more information faster and more efficiently, with a click of the mouse. The Internet allows consumers to shop for the features they want and compare similar offerings, even if these offerings are physically half a world apart. Moreover, businesses can access consumers directly, bypassing intermediaries, such as wholesalers, distributors, and retailers, and share some of the savings in the form of lower prices. Consumers can co-create products and personalize their purchases to fit more closely with their particular needs. Whether these are custom-fitting jeans, automobile features, or computer components, consumers can use the Internet and digital technologies to design their individualized products and purchase them online.

Already, the Internet and digital technologies have drastically accelerated and streamlined the process of acquiring supplies, procurement, ordering, and re-ordering of raw materials, parts, and components. Just-in-time processes rely on information systems to tightly coordinate activities and the flow of goods within the value chain and across suppliers and their customers. At the same time, procurement technologies can be imitated by competing suppliers, and technologies that make it possible to design and customize new products rapidly are being used by all competitors.

Because the Internet creates more tools and means for competing, rivalry among firms is likely to be more intense. Only those competing firms that can use digital technologies to give themselves a distinct image, create unique product offerings, or provide, faster, cheaper, and smarter services are likely to capture greater value with the new technology. Yet, such gains are hard to sustain because, in most cases, the new technology can be imitated quickly. The Internet tends to increase rivalry by making it difficult for firms to differentiate themselves and by lowering switching costs; customers can easily “shop around” for the best offering at the lowest price and readily compare products that technology brings virtually side by side and standardizes their differentiating features. The Internet and digital technologies drastically intervene and influence industry structures by affecting each one of the five forces in unique and different ways. These influences also change how companies develop and deploy strategies to create and sustain competitive advantages.

**Using Industry Analysis: A Few Caveats** For industry analysis to be valuable, a company must collect and evaluate a wide variety of information from many sources. As the trend toward globalization accelerates, information on foreign markets as well as on a wider variety of competitors, suppliers, customers, substitutes, and potential new entrants becomes more critical. Industry analysis helps a firm not only to evaluate the profit potential of an industry but also to consider various ways to strengthen its position vis-à-vis the five forces.

The five-forces analysis implicitly assumes a zero-sum game, determining how a firm can enhance its position relative to the forces. Yet, such an approach can often be short-sighted; that is, it can overlook the many potential benefits of developing constructive win–win relationships with suppliers and customers. Establishing long-term mutually beneficial relationships with suppliers improves a firm’s ability to implement just-in-time inventory systems, which allow it to manage inventories better and respond faster to market demands. Conversely, a company that exploits its powerful position against a supplier will likely face reprisal when the balance of power shifts. By working together as partners, suppliers and manufacturers can provide the greatest value at the lowest possible cost. Later chapters address such collaborative relationships and how they can be made most effective.
The five-forces analysis has also been criticized for being essentially a static analysis. However, this position rather reflects the way the analysis is typically used, and it misses two critical points that are reflective of the dynamic nature of the five-forces model. First, the model should not be used to describe the structure of an industry at a single moment in time. It might represent how various elements align in a single instant, but it does not convey how they got there nor the direction in which they are heading. Similarly, the five-forces analysis depicts an industry that might be converging or diverging, where firms are increasing or withdrawing from their involvement in various activities, and where developments are continuous or discontinuous. The analysis requires that managers elaborate on those issues before conclusions can be drawn.

Moreover, both scholars and practitioners recognize that external forces as well as strategies of individual firms are continually changing the structure of all industries. The search for a dynamic theory of strategy has led to greater use of game theory in industrial organization economics research and strategy research. On the basis of game theory considerations, Brandenburger and Nalebuff introduced the concept of the value net, which, in many ways, is an extension of the five-forces analysis (Exhibit 2.7). The value net represents all the players in the game and analyzes how their interactions affect a firm’s ability to generate and appropriate value. The vertical dimension of the net includes suppliers and customers. The firm has direct transactions with them. On the horizontal dimension are substitutes and complementors, players with whom a firm interacts but may not necessarily transact. The concept of complementors is perhaps the single most important contribution of value net analysis and hence is explained in more detail in the next paragraph.

Complementors typically are products or services that have possible impact on the value of a firm’s own products or services. Those who produce complements are usually referred to as complementors. Powerful computers are of no value to a user without the necessary software. Similarly, new and better software can be useful only with the hardware needed to run it. This is equally true in the video game industry, where the game consoles and video games complement each other. Nintendo’s success in the early 1990s

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**Exhibit 2.7**
The Value Net

Apple’s iPod: Relationships with Its Complementors

In 2002, Steve Jobs began his campaign to cajole the major music companies into selling tracks to iPod users through the iTunes Music Store. The music industry had been burned by illegal file-sharing services, such as Napster and Kazaa, and wanted nothing to do with digital music. Still, Jobs’s vision and commitment to safeguard against piracy persuaded them reluctantly to climb on board. The iPod was a phenomenal success, and both sides made a killing. The music companies received between 60 and 70 cents from each download, and the iTunes Music Store became a $4-billion business capturing 80 percent of the market for legal downloads.

By 2005, though, when the contracts came up for renewal, the relative power of the two sides had shifted. iTunes’s market dominance was instrumental in Apple’s meteoric success in the sales of iPods, and the firm had little interest in seeing these sales being jeopardized by a price increase of the music download tracks. Apple was adamant about keeping the price of a download at 99 cents although the music companies wanted to charge $1.50 or $2 for some of the more popular tracks. Negotiations were less than win–win, and Apple’s complementors had no choice but to relent.

Strategy Spotlight 2.7

was a result of its ability to manage its relationship with its complementors. It built a security chip into the hardware and then licensed the right to develop games to external firms. These firms paid a royalty to Nintendo for each copy of the game sold. The royalty revenue enabled Nintendo to sell game consoles at close to their cost, thereby increasing their market share; this, in turn, caused more games to be sold and more royalties to be generated. Yet, complementors have their own interests. It would be naïve to assume that they would always sacrifice their own interests for the good of the partnership. Strategy Spotlight 2.7 shows how Apple’s relationship with its complementors evolved over the last few years with the success of the iPod.

Finally, it is worth noting that the point of industry analysis is not to declare the industry attractive or unattractive but to understand the underpinnings of competition and the root causes of profitability. As much as possible, analysts should look at industry structure quantitatively, rather than be satisfied with lists of qualitative factors. Many elements of the five forces can be quantified: the percentage of the buyer’s total cost accounted for by the industry’s product can signal buyer price sensitivity, or the percentage of industry sales required to fill a plant or operate a logistical network to efficient scale can suggest economies of scale and help appreciate barriers to entry.

Strategic Groups within Industries

In an industry analysis, two assumptions are unassailable: (1) No two firms are totally different; and (2) no two firms are exactly the same. The analysis can be enhanced by identifying groups of firms that are mostly similar to each other, which are known as strategic groups. This is important because rivalry tends to be greater among firms that are alike. Canadian Tire is more concerned about Wal-Mart than about Holt Renfrew; Mercedes is more concerned about BMW than about Hyundai; and the Hudson’s Bay Company is more concerned about Sears than about Mac cosmetics stores.

The concept of strategic groups is, however, more complex than these examples may convey. Classifying an industry into strategic groups involves judgment. If it is to be useful as an analytical tool, one must exercise caution in deciding what dimensions to use to map the firms. Dimensions include breadth of product and geographic scope, price or quality,
degree of vertical integration, type of distribution (e.g., dealers, mass merchandisers, private label), and so on. Dimensions should also be selected to reflect the variety of strategic combinations in an industry. For example, if all firms in an industry have roughly the same level of product differentiation (or R&D intensity), this would not be a good dimension to select.

What is the value of the concept of strategic groups as an analytical tool? First, strategic groupings help a firm identify barriers to mobility, which protect a group from attacks by other groups. Mobility barriers are factors that deter the movement of firms from one strategic position to another. For example, in the chainsaw industry, the major barriers protecting the high-quality or dealer-oriented group are technology, brand image, and an established network of servicing dealers.

The second value of strategic grouping is that it helps a firm identify groups whose competitive position may be marginal or tenuous. One may anticipate that these competitors may exit the industry or try to move into another group. This has been the case in recent years in the retail department store industry, where firms such as J. C. Penney, the Hudson’s Bay Company, and Kmart have experienced extremely difficult times because they were stuck in the middle—neither an aggressive discount player like Wal-Mart nor a prestigious upscale player like Holt Renfrew.

Third, strategic groupings help chart the future directions of firms’ strategies. Arrows emanating from each strategic group can represent the direction in which the group (or a firm within the group) seems to be moving. If all strategic groups are moving in a similar direction, this could indicate a high degree of future volatility and intensity of competition. In the automobile industry, for example, the competition in the minivan and sport utility segments has intensified in recent years as many firms have entered those product segments.

Fourth, strategic groups are helpful in thinking through the implications of each industry trend. Is the trend decreasing the viability of a group? If so, in what direction should the strategic group move? Is the trend increasing or decreasing entry barriers in a given group? Will the trend decrease the ability of one group to separate itself from other groups? Such analysis can help in making predictions about industry evolution. A sharp increase in interest rates, for example, would tend to have less impact on providers of higher-priced goods (e.g., Porsche) than on providers of lower-priced goods (e.g., Dodge Neon). The Dodge Neon customer base is much more price sensitive.

Exhibit 2.8 provides a strategic grouping of the worldwide automobile industry. In this case, we have identified four strategic groups. In the top left-hand corner are high-end luxury automakers, who focus on a very narrow product market. Most of the cars produced by the members of this group cost well over $100,000. Some cost many times that amount. The Ferrari F50 costs roughly $500,000 and the Lamborghini L147 $270,000. Players in this market have a very exclusive clientele and face little rivalry from other strategic groups. At the other extreme, in the lower left-hand corner, is a strategic group that identifies with low-price, simple features, still narrow product range and targets a narrow market. These players, Hyundai and Kia, limit competition from other strategic groups by pricing their products as low as possible. Another group, near the middle, consists of firms high in product pricing and quality and average in their product-line breadth. The final group, at the far right, consists of firms with a broad range of products and multiple price points. These firms have entries that compete at both the lower end of the market (e.g., Ford Focus) and the higher end (e.g., Chevrolet Corvette).

It is true that the auto market has been very dynamic and that competition has intensified in recent years. Firms from different groups have come to compete in the same product markets, such as minivans and sport utility vehicles. Against GM’s and Toyota’s very successful SUVs, Mercedes entered the fray with the M series at the same time that BMW
introduced the X5. Porsche also made an entry with Cayenne. In another series of moves, Toyota, Nissan, and Honda have successfully introduced Lexus, Infiniti, and Acura, respectively, to compete for the same upscale market. Someone may interpret these moves as retaliatory intrusions in each other’s territory. Finally, a series of recent entries are likely to intensify the situation further in the foreseeable future; China’s Zhejiang Geely Holding Company, China’s Chery Automobile Company, and India’s Tata Motors are three firms from emerging markets. They have introduced models and are looking to carve a niche at an even lower point with new sub-compacts that are even smaller than what the market has been accustomed to. Chery’s QQ model sells for between $4,000 and $6,000 in the Chinese market and has horse power in the range of 51 to 74. Geely’s best selling four-door sedan retails around $6,500; to complicate things further, Geely also recently acquired Volvo, the venerable Swedish nameplate renown for its quality. Finally, Tata unveiled the Nano with an astonishing retail price of only $2,500 for a four-door, five-seat hatchback that gets 22 km per litre.

Summary

Managers must continuously analyze the external environment to minimize or eliminate threats and exploit opportunities. This involves a continuous process of environmental scanning and monitoring as well as obtaining competitive intelligence on present and potential rivals. These activities provide valuable inputs for developing forecasts. In addition, many firms use scenario planning to anticipate and respond to volatile and disruptive environmental changes.
We identified two types of environment: the general environment and the competitive environment. The six segments of the general environment are demographic/psychographic, sociocultural, political/legal, technological, economic, and global. Trends and events occurring in these segments, such as the aging of the population, higher percentages of women in the workplace, governmental legislation, and increasing (or decreasing) interest rates, can have a dramatic effect on a firm. A given trend or event may have a positive impact on some industries and a negative or neutral impact on others.

The competitive environment consists of industry-related factors and has a more direct impact than does the general environment. Porter’s five-forces model of industry analysis includes the threat of new entrants, buyer power, supplier power, threat of substitutes, and rivalry among competitors. The intensity of these factors determines, in large part, the average expected level of profitability in an industry. A sound awareness of such factors—in isolation and in combination—is beneficial not only for deciding what industries to enter but also for assessing how a firm can improve its competitive position. In employing the five-forces analysis, one should remember that it should not be viewed as a static model, recognize that it is based on an antagonistic view of the world, and find ways to consider complex interrelationships among a firm’s web of interactions and transactions. The general environment and the competitive environment are quite interdependent, and changes in one segment can greatly affect factors in another segment.

The concept of strategic groups is also important in analyzing the external environment of a firm. No two organizations are exactly the same, nor are they completely different. Firms can be placed in strategic groups on the basis of similarities in their resources and strategies. The concept of strategic groups is valuable for determining mobility barriers across groups, identifying groups with marginal competitive positions, charting the future directions of firm strategies, and assessing the implications of industry trends for the strategic group as a whole.

1. Why must managers be aware of a firm’s external environment?
2. What is gathering and analyzing competitive intelligence, and why is it important for firms to engage in it?
3. Discuss and describe the six elements of the external environment.
4. Select one of these elements, and describe some changes relating to it in an industry that interests you.
5. Describe how the five-forces analysis can be used to determine the average expected profitability in an industry.
6. What are some of the limitations (or caveats) in using the five-forces analysis?
7. Explain how the general environment and competitive environment are highly related. How can such interrelationships affect the profitability of a firm or industry?
8. Explain the concept of strategic groups. What are the performance implications?
**SWOT Analysis:** From a career standpoint, periodically, evaluate your strengths and weaknesses as well as potential opportunities and threats to your career. In addition, strive to seek input from trusted peers and colleagues.

**General Environment:** Evaluate the element of the general environment facing your firm. Identify factors, such as rapid technological change, that can provide promising career opportunities as well as possibilities for you to add value for your organization. In doing this, do not focus solely on internal factors of your organization.

**Five forces Analysis:** Consider the five-forces affecting the industry within which your organization competes. How does the picture look? What are the likely trends on each of the forces? How are they likely to change going forward? If the forces are unfavourable, the long-term profit potential of the industry may be unattractive. Are things likely to change? If not, there will likely be fewer resources and fewer career opportunities available.

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Select one of the following industries: personal computers, airlines, or automobiles. For this industry, evaluate the strength of each of Porter’s five forces as well as complementors.

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Application Questions Exercises

1. Imagine yourself as the CEO of a large firm in an industry that interests you. Then (a) identify major trends in the general environment, (b) analyze their impact on the firm, and (c) identify major sources of information to monitor these trends. (Use the Internet and your library’s resources.)

2. Analyze movements across the strategic groups in the Canadian retail industry. How do these movements within this industry change the nature of competition?

3. What are the major trends in the general environment that have impacted the Canadian financial services industry?

4. On the Internet, look up www.magna.ca. What are some of the forces driving industry competition affecting the profitability of this firm?
1. What are some of the legal and ethical issues involved in collecting competitor intelligence in the following situations?
   a. A firm hires an MBA student to collect information directly from the competition; during his contacts with the competitors, the student claims that the information is for a course project.
   b. A firm advertises a non-existent position and interviews a rival’s employees to obtain competitor information.
   c. A hotel sends an employee posing as a potential client to a competitor to find out how it handles new clients and who its major corporate customers are.

2. What are some of the ethical concerns that arise when a firm tries to exploit its power over a supplier?