

# 2

## The External Environment: Opportunities, Threats, Industry Competition, and Competitor Analysis

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*Studying this chapter should provide you with the strategic management knowledge needed to:*

- 1** Explain the importance of analyzing and understanding the firm's external environment.
- 2** Define and describe the general environment and the industry environment.
- 3** Discuss the four parts of the external environmental analysis process.
- 4** Name and describe the general environment's seven segments.
- 5** Identify the five competitive forces and explain how they determine an industry's profitability potential.
- 6** Define strategic groups and describe their influence on firms.
- 7** Describe what firms need to know about their competitors and different methods (including ethical standards) used to collect intelligence about them.



## THE COCA-COLA CO. AND PEPSICO: RIVALS COMPETING IN A CHALLENGING ENVIRONMENT



Recognized throughout the world, Coca-Cola and PepsiCo are both successful companies. At least historically, these firms are best known for their soft drinks or sodas.

Interestingly, some believe that the United States “has been defined by soda in the same way France defined its empire on wine, Germany on beer, and Britain on tea.”

Even though they differ in the total set of products they offer, the rivalry between these companies remains intense, particularly in terms of both carbonated and noncarbonated beverages. These competitions play out in many nations and regions of the world.

Of the two companies, PepsiCo is more diversified in that, through its Frito-Lay business unit, it is a leader in the global snack industry. The importance of this unit to PepsiCo is shown by the fact that it recently accounted for 21 percent of the firm’s sales

revenue but 35 percent of its operating profits. In contrast, Coca-Cola is the world’s largest producer of soft drink concentrates and syrups and is also the world’s largest producer of juice and juice-related products; however, it does not have a snack business unit.

Changing conditions in the external environment are affecting these firms’ competitive choices. Overall declining sales in the soda category in the United States in particular but in other parts of the world as well are one reason for this. Soda sales appear to be declining partly as a result of changes in societies’ attitudes toward the “value” associated with consuming soda products, particularly full-calorie versions of them. In response, Coca-Cola is finding ways to generate more returns through its juice products. To ensure access to the supply of oranges it needs, the firm recently established long-term leases with two large Florida growers. This deal gives Coca-Cola access

to the production of 5 million orange trees for a period of 20 years. PepsiCo’s recent competitive actions include paying \$4.2 billion for Russian yogurt giant Wimm-Bill-Dann Foods. This is PepsiCo’s largest-ever foreign acquisition and is seen as a path to reach consumers in neighboring countries such as Ukraine, Turkmenistan, and Kyrgyzstan for the purpose of successfully distributing its Frito-Lay products.

In addition, these firms continue competing aggressively against each other in sodas. Each firm has developed fountain machines that allow customers to create a variety of flavor combinations, such as strawberry Mountain Dew (a Pepsi-Cola product). To better attract younger consumers, PepsiCo completed an endorsement deal with pop star Beyoncé. And both firms are competing against each other to gain market share in noncarbonated beverage products such as waters, juices, and sports drinks.

Suggested links between obesity and some of these firms' products is another condition in the external environment that is affecting these firms, causing them to compete against each other to find ways to most effectively respond to this threat. Coca-Cola has announced that it is committed to contributing to individuals' health on a global basis. Supporting physical activities programs in every country where the firm competes is one action it is taking to demonstrate this commitment. In addition to committing to sell healthier products through its Quaker Oats, Gatorade, and Tropicana divisions, PepsiCo has established the "Global Nutrition Group" for the purpose of developing breakthrough products that will satisfy customers' needs for enjoyable but healthy products.

Sources: 2013, Coca-Cola Co, *Standard & Poor's Stock Report*, [www.standardandpoors.com](http://www.standardandpoors.com), May 17; 2013, PepsiCo Inc., *Standard & Poor's Stock Report*, [www.standardandpoors.com](http://www.standardandpoors.com), May 17; A. Cardenal, 2013, The battle of the soda giants: Coke vs. Pepsi, [www.beta.fool.com](http://www.beta.fool.com), April 10; C. Passy, 2013, Why soda is the great American beverage, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), March 12; D. Stanford, 2013, Cola-Cola expands calorie labels and emphasizes no-cals, *Bloomberg Businessweek*, [www.businessweek.com](http://www.businessweek.com), May 9; D. Stanford, 2013, PepsiCo's East European snack attack, *Bloomberg Businessweek*, [www.businessweek.com](http://www.businessweek.com), February 28; K. Stock, 2013, Coke's sweet \$2 billion orange juice deal, *Bloomberg Businessweek*, [www.businessweek.com](http://www.businessweek.com), May 8.

As described in the Opening Case and suggested by research, the external environment (which includes the industry in which a firm competes as well as those against whom it competes) affects the competition actions and responses firms take to outperform competitors and earn above-average returns.<sup>1</sup> For example, Coca-Cola and PepsiCo are trying to effectively address the allegation that some and perhaps many of their products contribute to obesity. The socio-cultural segment of the general environment (discussed in this chapter) is the source of this allegation and the threat it represents to the two firms. The Opening Case also describes some of the ways these two firms compete against each other in markets throughout the world.

As noted in Chapter 1, the characteristics of today's external environment differ from historical conditions. For example, technological changes and the continuing growth of information gathering and processing capabilities increase the need for firms to develop effective competitive actions and responses on a timely basis.<sup>2</sup> (We fully discuss competitive actions and responses in Chapter 5.) Additionally, the rapid sociological changes occurring in many countries affect labor practices and the nature of products that increasingly diverse consumers demand. Governmental policies and laws also affect where and how firms choose to compete.<sup>3</sup> And, changes to a number of nations' financial regulatory systems that have been enacted since 2010 are expected to increase the complexity of organizations' financial transactions.<sup>4</sup>

Firms understand the external environment by acquiring information about competitors, customers, and other stakeholders to build their own base of knowledge and capabilities.<sup>5</sup> On the basis of the new information, firms take actions, such as building new capabilities and core competencies, in hopes of buffering themselves from any negative environmental effects and to pursue opportunities as the basis for better serving their stakeholders' needs.<sup>6</sup>

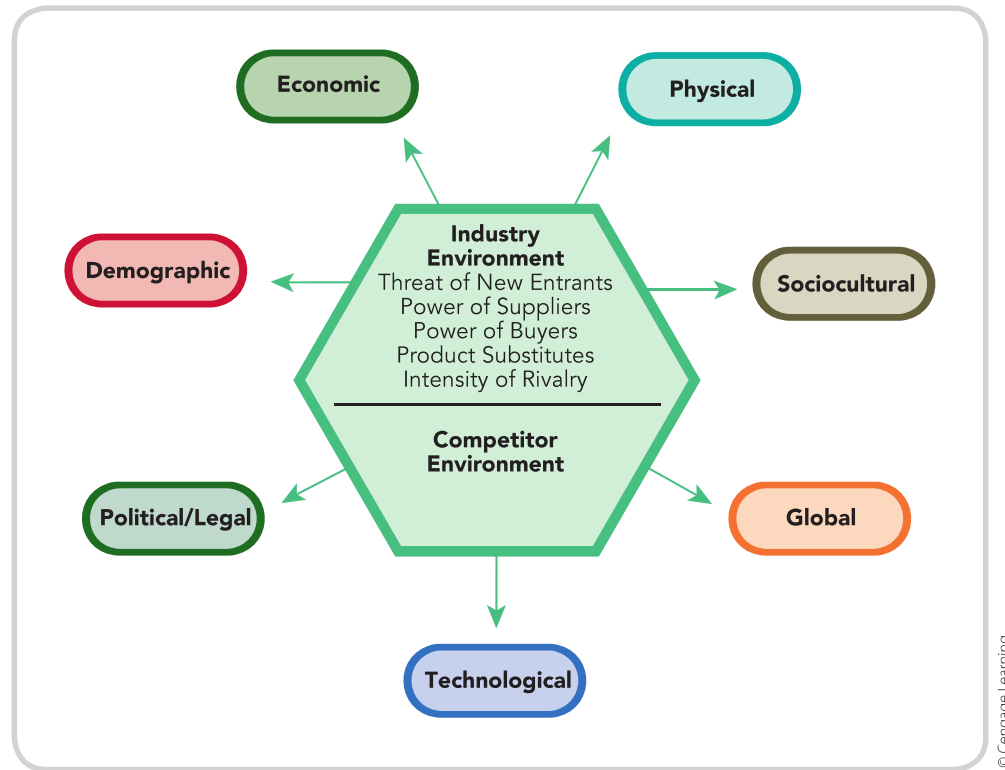
In summary, a firm's competitive actions and responses are influenced by the conditions in the three parts (the general, industry, and competitor) of its external environment (see Figure 2.1) and its understanding of those conditions. Next, we fully describe each part of the firm's external environment.

## 2-1 The General, Industry, and Competitor Environments

The **general environment** is composed of dimensions in the broader society that influence an industry and the firms within it.

The **general environment** is composed of dimensions in the broader society that influence an industry and the firms within it.<sup>7</sup> We group these dimensions into seven environmental *segments*: demographic, economic, political/legal, sociocultural, technological, global, and physical. Examples of *elements* analyzed in each of these segments are shown in Table 2.1.

**Figure 2.1** The External Environment



Firms cannot directly control the general environment's segments. Accordingly, what a company seeks to do is recognize trends in each segment of the general environment and then *predict* each trend's effect on it. For example, some believe that over the next 10 to 20 years, millions of people living in emerging market countries will join the middle class. Of course no firm, including large multinationals, is able to control where growth in potential customers may take place in the next decade or two. Nonetheless, firms must study this anticipated trend as a foundation for predicting its effects on their ability to identify strategies to use that will allow them to remain successful as market conditions change.<sup>8</sup>

The **industry environment** is the set of factors that directly influences a firm and its competitive actions and responses:<sup>9</sup> the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes, and the intensity of rivalry among competing firms. In total, the interactions among these five factors determine an industry's profitability potential; in turn, the industry's profitability potential influences the choices each firm makes about its competitive actions and responses. The challenge for a firm is to locate a position within an industry where it can favorably influence the five factors or where it can successfully defend itself against their influence. The greater a firm's capacity to favorably influence its industry environment, the greater the likelihood it will earn above-average returns.

How companies gather and interpret information about their competitors is called **competitor analysis**. Understanding the firm's competitor environment complements the insights provided by studying the general and industry environments.<sup>10</sup> This means, for example, that Coca-Cola and PepsiCo want to learn as much about each other as they can while each company simultaneously seeks to understand its general and industry environments.

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**Table 2.1** The General Environment: Segments and Elements

|                              |                                                                                                                                                                                                               |                                                                                                                                                                                               |
|------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Demographic segment          | <ul style="list-style-type: none"> <li>Population size</li> <li>Age structure</li> <li>Geographic distribution</li> </ul>                                                                                     | <ul style="list-style-type: none"> <li>Ethnic mix</li> <li>Income distribution</li> </ul>                                                                                                     |
| Economic segment             | <ul style="list-style-type: none"> <li>Inflation rates</li> <li>Interest rates</li> <li>Trade deficits or surpluses</li> <li>Budget deficits or surpluses</li> </ul>                                          | <ul style="list-style-type: none"> <li>Personal savings rate</li> <li>Business savings rates</li> <li>Gross domestic product</li> </ul>                                                       |
| Political/Legal segment      | <ul style="list-style-type: none"> <li>Antitrust laws</li> <li>Taxation laws</li> <li>Deregulation philosophies</li> </ul>                                                                                    | <ul style="list-style-type: none"> <li>Labor training laws</li> <li>Educational philosophies and policies</li> </ul>                                                                          |
| Sociocultural segment        | <ul style="list-style-type: none"> <li>Women in the workforce</li> <li>Workforce diversity</li> <li>Attitudes about the quality of work life</li> </ul>                                                       | <ul style="list-style-type: none"> <li>Shifts in work and career preferences</li> <li>Shifts in preferences regarding product and service characteristics</li> </ul>                          |
| Technological segment        | <ul style="list-style-type: none"> <li>Product innovations</li> <li>Applications of knowledge</li> </ul>                                                                                                      | <ul style="list-style-type: none"> <li>Focus of private and government-supported R&amp;D expenditures</li> <li>New communication technologies</li> </ul>                                      |
| Global segment               | <ul style="list-style-type: none"> <li>Important political events</li> <li>Critical global markets</li> </ul>                                                                                                 | <ul style="list-style-type: none"> <li>Newly industrialized countries</li> <li>Different cultural and institutional attributes</li> </ul>                                                     |
| Physical environment segment | <ul style="list-style-type: none"> <li>Energy consumption</li> <li>Practices used to develop energy sources</li> <li>Renewable energy efforts</li> <li>Minimizing a firm's environmental footprint</li> </ul> | <ul style="list-style-type: none"> <li>Availability of water as a resource</li> <li>Producing environmentally friendly products</li> <li>Reacting to natural or man-made disasters</li> </ul> |

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An analysis of the general environment focuses on environmental trends and their implications, an analysis of the industry environment focuses on the factors and conditions influencing an industry’s profitability potential, and an analysis of competitors is focused on predicting competitors’ actions, responses, and intentions. In combination, the results of these three analyses influence the firm’s vision, mission, its choice of strategies, and the competitive actions and responses it will take to implement those strategies. Although we discuss each analysis separately, performance improves when the firm effectively integrates the insights provided by analyses of the general environment, the industry environment, and the competitor environment.

## 2-2 External Environmental Analysis

Most firms face external environments that are turbulent, complex, and global—conditions that make interpreting those environments difficult.<sup>11</sup> To cope with often ambiguous and incomplete environmental data and to increase understanding of the general environment, firms complete an *external environmental analysis*. This analysis has four parts: scanning, monitoring, forecasting, and assessing (see Table 2.2).

Identifying opportunities and threats is an important objective of studying the general environment. An **opportunity** is a condition in the general environment that, if exploited effectively, helps a company reach strategic competitiveness. Most companies—and certainly large ones—continuously encounter multiple opportunities as well as threats.

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**Table 2.2** Parts of the External Environment Analysis

|             |                                                                                                                        |
|-------------|------------------------------------------------------------------------------------------------------------------------|
| Scanning    | • Identifying early signals of environmental changes and trends                                                        |
| Monitoring  | • Detecting meaning through ongoing observations of environmental changes and trends                                   |
| Forecasting | • Developing projections of anticipated outcomes based on monitored changes and trends                                 |
| Assessing   | • Determining the timing and importance of environmental changes and trends for firms' strategies and their management |

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In terms of possible opportunities, we can note that a combination of cultural, political, and economic factors is resulting in rapid retail growth in Africa and the Middle East as well as in Latin America. Accordingly Walmart, the world's largest retailer, and the next three largest global giants (France's Carrefour, U.K.-based Tesco, and Germany's Metro) are planning to expand in these regions. "Walmart is expanding its horizon to Chile, India and South Africa; Carrefour will open stores in Bulgaria, India and Iran. Tesco is also opening stores in India, and Metro will open in Egypt and Kazakhstan."<sup>12</sup> Similarly, Google intends to partner with local telecommunications firms and equipment providers to help build and operate wireless networks in emerging markets such as sub-Saharan Africa and Southeast Asia. Pursuing these opportunities is part of Google's goal of connecting a billion or more new users to the Internet.<sup>13</sup>

A **threat** is a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness.<sup>14</sup> Finnish-based Nokia Corp. is dealing with threats including one regarding its intellectual property rights. In roughly mid-2013, the company filed two additional complaints against competitor HTC Corp. alleging that the Taiwanese smartphone manufacturer had infringed on nine of Nokia's patents.<sup>15</sup> This threat obviously deals with the political/legal segment. From the technological segment, Nokia is facing a potential threat from a new device called Jolla. Created by former Nokia executives and developers who founded their own firm in Helsinki in 2011, its manufacturer believes that the Jolla operating system is "a truly independent and open alternative in mobile."<sup>16</sup> While its competitive success is yet to be determined, this product does appear to represent a technological threat for Nokia and others smartphone manufacturers as well.

Firms use multiple sources to analyze the general environment through scanning, monitoring, forecasting, and assessing. Examples of these sources include a wide variety of printed materials (such as trade publications, newspapers, business publications, and the results of academic research and public polls), trade shows and suppliers, customers, and employees of public-sector organizations. Of course, the information available from Internet sources is of increasing importance to a firm's efforts to study the general environment.

2-2a **Scanning**

*Scanning* entails the study of all segments in the general environment. Although challenging, scanning is critically important to firms' efforts to understand trends in the general environment and predict their implications. This is particularly the case for companies competing in highly volatile environments.<sup>17</sup>

Through scanning, firms identify early signals of potential changes in the general environment and detect changes that are already under way.<sup>18</sup> Scanning activities must be aligned with the organizational context; a scanning system designed for a volatile environment is inappropriate for a firm in a stable environment.<sup>19</sup> Scanning often reveals ambiguous, incomplete, or unconnected data and information that require careful analysis.

Many firms use special software to help them identify events that are taking place in the environment and that are announced in public sources. For example, news event detection

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uses information-based systems to categorize text and reduce the trade-off between an important missed event and false alarm rates. Increasingly, these systems are used to study social media outlets as sources of information.<sup>20</sup>

Broadly speaking, the Internet provides a wealth of opportunities for scanning. Amazon.com, for example, records information about individuals visiting its Web site, particularly if a purchase is made. Amazon then welcomes these customers by name when they visit the Web site again. The firm sends messages to customers about specials and new products similar to those they purchased in previous visits. A number of other companies, such as Netflix, also collect demographic data about their customers in an attempt to identify their unique preferences (demographics is one of the segments in the general environment).

## 2-2b Monitoring

When *monitoring*, analysts observe environmental changes to see if an important trend is emerging from among those spotted through scanning.<sup>21</sup> Critical to successful monitoring is the firm's ability to detect meaning in environmental events and trends. For example, those monitoring retirement trends in the United States learned in 2013 that 57 percent of U.S. workers surveyed reported that excluding the value of their home, they have only \$25,000 or less in savings and investments set aside for their retirement. This particular survey also discovered "that 28% of Americans have no confidence they will have enough money to retire comfortably—the highest level in the (survey's) 23-year history."<sup>22</sup> Historically, U.S. workers saved larger percentages of their earned income as a foundation for retirement. Firms seeking to serve retirees' financial needs will continue monitoring this change in workers' savings and investment patterns to see if a trend is developing. Once convinced that saving less for retirement is indeed a trend, these firms will seek to understand its competitive implications.

Effective monitoring requires the firm to identify important stakeholders and understand its reputation among these stakeholders as the foundation for serving their unique needs.<sup>23</sup> (Stakeholders' unique needs are described in Chapter 1.) Scanning and monitoring are particularly important when a firm competes in an industry with high technological uncertainty.<sup>24</sup> Scanning and monitoring can provide the firm with information; these activities also serve as a means of importing knowledge about markets and about how to successfully commercialize the new technologies the firm has developed.<sup>25</sup>

A variety of microprocessors are displayed at the Mobile World Congress in Barcelona, Spain. The global showcase for the mobile technology industry draws 1,500 exhibitors to discuss the future of wireless communication.



Bloomberg/Getty Images

## 2-2c Forecasting

Scanning and monitoring are concerned with events and trends in the general environment at a point in time. When *forecasting*, analysts develop feasible projections of what might happen, and how quickly, as a result of the events and trends detected through scanning and monitoring.<sup>26</sup> For example, analysts might forecast the time that will be required for a new technology to reach the marketplace, the length of time before different corporate training procedures are required to deal with anticipated changes in the composition of the workforce, or how much time will elapse before changes in governmental taxation policies affect consumers' purchasing patterns.

Forecasting events and outcomes accurately is challenging. Forecasting demand for new technological products is difficult because technology trends are continually driving product life cycles shorter. This is particularly difficult for a firm such as Intel, whose products go into many customers' technological products, which are consistently updated. Increasing the difficulty, each new wafer fabrication or silicon chip technology production plant in which Intel invests becomes significantly more expensive for each generation of chip products. In this instance, having access to tools that allow better forecasting of electronic product demand is of value to Intel as the firm studies conditions in its external environment.<sup>27</sup>

## 2-2d Assessing

When *assessing*, the objective is to determine the timing and significance of the effects of environmental changes and trends that have been identified.<sup>28</sup> Through scanning, monitoring, and forecasting, analysts are able to understand the general environment. Going a step further, the intent of assessment is to specify the implications of that understanding. Without assessment, the firm is left with data that may be interesting but of unknown competitive relevance. Even if formal assessment is inadequate, the appropriate interpretation of that information is important.

Accurately assessing the trends expected to take place in the segments of a firm's general environment is important. However, accurately interpreting the meaning of those trends is even more important. In slightly different words, although gathering and organizing information is important, appropriately interpreting the intelligence the collected information provides to determine if an identified trend in the general environment is an opportunity or threat is critical.<sup>29</sup>

## 2-3 Segments of the General Environment

The general environment is composed of segments that are external to the firm (see Table 2.1). Although the degree of impact varies, these environmental segments affect all industries and the firms competing in them. The challenge to each firm is to scan, monitor, forecast, and assess the elements in each segment to predict their effects on it. Effective scanning, monitoring, forecasting, and assessing are vital to the firm's efforts to recognize and evaluate opportunities and threats.

### 2-3a The Demographic Segment

The **demographic segment** is concerned with a population's size, age structure, geographic distribution, ethnic mix, and income distribution.<sup>30</sup> Demographic segments are commonly analyzed on a global basis because of their potential effects across countries' borders and because many firms compete in global markets.

#### Population Size

The world's population doubled (from 3 billion to 6 billion) between 1959 and 1999. Current projections suggest that population growth will continue in the twenty-first century, but at a slower pace. The U.S. Census Bureau projects that the world's population will be 9 billion by 2042 and roughly 9.25 billion by 2050.<sup>31</sup> In 2012, China was the world's largest country by population with over 1.3 billion people. By 2050, however, India is expected to be the most populous nation in the world (approximately 1.69 billion). China (1.3 billion), the United States (439 million), Indonesia (313 million), and Pakistan (276 million) are expected to be the next four most populous countries in 2050.<sup>32</sup> Firms seeking to find growing markets in which to sell their goods and services want to recognize the market potential that may exist for them in these five nations.

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While observing the population of nations and regions of the world, firms also want to study changes occurring within different populations to assess their strategic implications. For example, in 2011, 23 percent of Japan's citizens were 65 or older, while the United States and China will not reach this level until 2036.<sup>33</sup> Aging populations are a significant problem for countries because of the need for workers and the burden of supporting retirement programs. In Japan and some other countries, employees are urged to work longer to overcome these problems.

### Age Structure

The most noteworthy aspect of this element of the demographic segment is that the world's population is rapidly aging. For example, predictions are that, "By 2050, over one-fifth of the U.S. population will be 65 or older up from the current figure (in 2012) of one-seventh. The number of centenarians worldwide will double by 2023 and double again by 2035. Projections suggest life expectancy will surpass 100 in some industrialized countries by the second half of this century—roughly triple the lifespan that prevailed worldwide throughout most of human history."<sup>34</sup> In China, the 65 and over population is expected to reach roughly 330 million by 2050, which will be close to one-fourth of the nation's total population.<sup>35</sup> In the 1950s, Japan's population was one of the youngest in the world. However, 45 is now the median age in Japan, with the projection that it will be 55 by 2040. With a fertility rate that is below replacement value, another prediction is that by 2040, there will be almost as many Japanese people 100 years old or older as there are newborns.<sup>36</sup>

These predictions lead to different possibilities. In Japan, an expectation that the working age population will shrink from 81 million in 2012 to about 57 million in 2040 seems to threaten companies' ability to operate. On the other hand, is there an opportunity for Japanese firms to find ways to increase the productivity of their workers and/or to establish additional operations in other nations? From an opportunity perspective, delayed retirements of baby boomers (those born between 1947 and 1965) that are expected in the United States (and perhaps other countries as well) create the possibility of helping companies "avoid or defer the baby-boomer brain drain that has been looming for so long." In this sense, "organizations now have a fresh opportunity to address the talent gap created by a shortage of critical skills in the marketplace as well as the experience gap created by multiple waves of downsizing over the past decade."<sup>37</sup> Having those delaying their retirement use their knowledge to help younger employees quickly gain valuable skills is another opportunity that the age structure element suggests firms should consider.

### Geographic Distribution

How a population is distributed within countries and regions is subject to change over time. For example, the last few decades have seen the U.S. population shifting from states in the Northeast and Great Lakes region to states in the west (California), south (Florida), and southwest (Texas). These changes can be seen as moving from the "Frost Belt" to the "Sun Belt." Outcomes from these shifts include the facts that the gross domestic product (GDP) of California in 2011 was just under \$2 trillion, an amount that makes California the ninth-largest economy in the world. In this same year, at a value of \$1.3 trillion, Texas' GDP was second to that of California.<sup>38</sup>

Recent shifts show that New Jersey had the highest ratio of people moving out compared to the number of people moving into the state in 2012. Illinois, New York, Michigan, Maine, Connecticut, and Wisconsin are additional states for which a large net migration occurred in 2012. In a shift in the pattern witnessed for the first decade-plus of the twenty-first century, Washington, D.C., was the most popular destination for relocation in 2012 with Oregon being the second most popular. Washington, D.C., seemed to be popular because of its somewhat recession-proof economic opportunities that are generated by a maturing high-tech sector and federal government jobs. In particular, the city of Portland appears to

capture the allure of Oregon in terms of its mix of economic growth, cutting edge urban planning, and scenic landscapes.<sup>39</sup>

Firms want to carefully study the patterns of population distributions in countries and regions to identify opportunities and threats. Thus in the United States, current patterns suggest the possibility of opportunities in Washington, D.C., as well as in states on the West Coast including Oregon and those in the South and Southwest. In contrast, firms competing in the Northeast and Great Lakes areas may concentrate on identifying threats to their ability to operate profitably in those areas.

Of course, geographic distribution patterns differ throughout the world. For example, in China, the majority of the population still lives in rural areas; however, today's growth patterns are toward urban communities such as Shanghai and Beijing.<sup>40</sup> Shifts that occurred between 2011 and 2012 in Europe show net (but small) population gains for countries such as France, Germany, and the United Kingdom while Greece experienced a net (again, small) population decline. Overall, the geographic distribution patterns at least for this year in Europe were quite stable.<sup>41</sup> This fact too has relevance for firms studying this segment of their general environment.

### Ethnic Mix

The ethnic mix of countries' populations continues to change, creating opportunities and threats for many companies as a result. For example, Hispanics are now the largest ethnic minority in the United States.<sup>42</sup> In fact, the U.S. Hispanic market is the third largest "Latin American" economy behind Brazil and Mexico. Spanish is now the dominant language in parts of U.S. states such as Texas, California, Florida, and New Mexico. Given these facts, some firms might want to assess the degree to which their goods or services could be adapted to serve the unique needs of Hispanic consumers.

Additional evidence is of interest to firms when examining this segment. For example, African countries are the most ethnically diverse in the world, with Uganda having the highest ethnic diversity rating with Liberia second. In contrast, Japan and the Koreas are the least diversified from the perspective of a mix of ethnicities in their populations. European countries are ethnically homogeneous while the Americas are often diverse. "From the United States through Central America down to Brazil, the 'new world' countries, maybe in part because of their histories of relatively open immigration (and, in some cases, intermingling between natives and new arrivals) tend to be pretty diverse."<sup>43</sup>

### Income Distribution

Understanding how income is distributed within and across populations informs firms of different groups' purchasing power and discretionary income. Of particular interest to firms are the average incomes of households and individuals. For instance, the increase in dual-career couples has had a notable effect on average incomes. Although real income has been declining in general in some nations, the household income of dual-career couples has increased, especially in the United States. These figures yield strategically relevant information for firms. For instance, research indicates that whether an employee is part of a dual-career couple can strongly influence the willingness of the employee to accept an international assignment. However, because of recent global

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*Patterns of population distribution present both opportunities and threats to companies.*





economic conditions, many companies were still pursuing international assignments but changing them to avoid some of the additional costs of funding expatriates abroad.<sup>44</sup>

The growth of the economy in China has drawn many firms, not only for the low-cost production, but also because of the large potential demand for products, given its large population base. However, in recent times, the amount of China's gross domestic product that makes up domestic consumption is the lowest of any major economy at less than one-third. In comparison, India's domestic consumption of consumer goods accounts for two-thirds of its economy, or twice China's level. As such, many western multinationals are considering entering India as a consumption market as its middle class grows extensively. Although India as a nation has poor infrastructure, its consumers are in a better position to spend. Furthermore, the urban-rural income difference has been declining in India more rapidly than in China. Because of situations such as this, paying attention to the differences between markets based on income distribution can be very important.<sup>45</sup>

## 2-3b The Economic Segment

The **economic environment** refers to the nature and direction of the economy in which a firm competes or may compete.<sup>46</sup> In general, firms seek to compete in relatively stable economies with strong growth potential. Because nations are interconnected as a result of the global economy, firms must scan, monitor, forecast, and assess the health of their host nation as well as the health of the economies outside it.

For firms studying the economic environment today for purposes of being able to predict trends that may occur in this segment of the general environment and their effects on them, the picture remains unclear and challenging. There are at least two reasons for this. First, the global recession of 2008 and 2009 created numerous problems for companies throughout the world, including those of reduced consumer demand, increases in firms' inventory levels, development of additional governmental regulations, and a tightening of access to financial resources. The second reason to consider is that the global recovery from the 2008 and 2009 recession remains persistently slow and relatively weak compared to previous recoveries. Some argue that enhanced *economic uncertainty* (which refers to an environment in which relatively little and perhaps nothing at all is known about the future state of an economy) is a major cause of the "less-than-robust-recovery" that was experienced at least through mid-2013. Of likely concern to firms studying the economic segment today is the fact that historically, high degrees of economic uncertainty coincide with periods of lower growth. And again, according to some research, "it is clear that (economic) uncertainty has increased in recent times."<sup>47</sup> This increase suggests the possibility of slower growth in the foreseeable future.

When facing economic uncertainty, firms want to be certain to study the economic environment in multiple regions and countries throughout the world. Although economic growth remains relatively weak and economic uncertainty has been strong in Europe and the United States in recent times, this was not the case in other settings. In 2013, for example, growth was projected to increase by 8.2 percent in China, by 4 percent in Brazil, and by 3.5 percent in Mexico. From a regional perspective, 2013 projections were for growth of 5.8 percent in Southeast Asia and 5.7 percent in sub-Saharan Africa, estimates that highlight the anticipation of the continuing development of emerging economies.<sup>48</sup> Ideally, firms will be able to pursue growth opportunities in regions and nations where they exist while avoiding the threats of slow growth periods in other settings.

## 2-3c The Political/Legal Segment

The **political/legal segment** is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various local governmental agencies.<sup>49</sup> Essentially, this segment is concerned with how organizations try to influence

The **economic environment** refers to the nature and direction of the economy in which a firm competes or may compete.

The **political/legal segment** is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various local governmental agencies.



governments and how they try to understand the influences (current and projected) of those governments on their competitive actions and responses. Commonly, firms develop a political strategy to specify how they will study the political/legal segment as well as approaches they might take (such as lobbying efforts) in order to successfully deal with opportunities and threats that surface within this segment at different points in time.<sup>50</sup>

Regulations formed in response to new national, regional, state, and/or local laws that are legislated often influence a firm's competitive actions and responses. For example, the state of Nevada in the United States recently legalized the business of online poker/gambling. New Jersey and Delaware quickly took the same action. In response to Nevada's regulatory change, firms such as MGM Resorts International were trying to decide the degree to which these decisions represented a viable opportunity. According to a MGM official, the immediate concern with respect to Nevada is that "the state may be too small to provide a lucrative online market on a standalone basis."<sup>51</sup>

At a regional level, changes in the laws regarding the appropriate regulation of European banks are still being actively debated.<sup>52</sup> For interactive, technology-based firms such as Facebook, Google, and Amazon, among others, "the effort in Europe to adopt the world's strongest data protection law has drawn the attention of dozens of lobbyists from U.S. technology and advertising companies."<sup>53</sup> Highly restrictive laws about consumer privacy could threaten how these firms conduct business in the European Union. Finally, in a comprehensive sense, recent transformations from state-owned to private firms occurring in multiple nations have substantial implications for the competitive landscapes in a number of countries and across multiple industries.<sup>54</sup>

### 2-3d The Sociocultural Segment

The **sociocultural segment** is concerned with a society's attitudes and cultural values. Because attitudes and values form the cornerstone of a society, they often drive demographic, economic, political/legal, and technological conditions and changes.

Individual societies' attitudes and cultural orientations are anything other than stable, meaning that firms must carefully scan, monitor, forecast, and assess them to recognize and study associated opportunities and threats. Another way of thinking about this is to note that companies do not exist in an isolated state. Because of this, even successful firms must have an awareness of changes taking place in the societies and their associated cultures in which they are competing. Indeed, societal and culture changes challenge firms to find ways to "adapt to stay ahead of their competitors and stay relevant in the minds of their consumers."<sup>55</sup>

Attitudes about and approaches to health care are issues being considered in nations and regions throughout the world. For Europe, the European Commission has developed a health care strategy for all of Europe that is oriented to preventing diseases while tackling lifestyle factors influencing health such as nutrition, working conditions, and physical activity. This Commission argues that promoting attitudes to take care of one's health is especially important in the context of an aging Europe as shown by the projection that the proportion of people over 65 living in Europe will increase from 17 percent in 2010 to almost 30 percent by 2060.<sup>56</sup>

In the United States, costs remain at the forefront of discussions about health care. Recent surveys show that consumers are dissatisfied with the cost of health care and do not understand why these costs continue to increase. Simultaneously though, most patients (as many as 80 percent of women and 85 percent of men) fail to compare the costs of doctors and recommended procedures.<sup>57</sup> At issue for business firms is that attitudes and values about health care can affect them; accordingly, they must carefully examine trends regarding health care in order to anticipate the effects on their operations.

As the U.S. labor force has increased, it has become more diverse, as significantly more women and minorities from a variety of cultures enter the workplace. In 1993, the total U.S. workforce was slightly less than 130 million; in 2005, it was slightly greater than 148 million. It is predicted to grow to more than 192 million by 2050.

The **sociocultural segment** is concerned with a society's attitudes and cultural values.



Chris Sattlberger/Photographer's Choice RF/Getty Images

*Greater workforce diversity has become the norm in many industries. These changes have forced many companies to challenge the notion of traditional organizational roles for men and women.*

However, the rate of growth in the U.S. labor force has declined over the past two decades largely as a result of slower growth of the nation's population and because of a downward trend in the labor force participation rate. More specifically, data show that "after nearly five decades of steady growth, the overall participation rate—defined as the proportion of the civilian noninstitutional population in the labor force—peaked at an annual average of 67.1 percent for each year from 1997 to 2000... By September 2012, the rate had dropped to 63.6 percent"<sup>58</sup> and is expected to fall to 58.5 percent by 2050. Other changes in the U.S. labor force between 2010 and 2050 are expected. During this time period, the Asian labor force is projected to more than double in size while the growth in the white labor force is predicted to be much slower compared to other racial groups. In contrast, people of Hispanic origin are expected to account for roughly 80 per-

cent of the total growth in the labor force. Finally, "it is projected that the higher growth rate of the female labor force relative to that of men will end by 2020 and the growth rates for men and women will be similar for the 2020–2050 period."<sup>59</sup>

Greater diversity in the workforce creates challenges and opportunities, including combining the best of both men's and women's traditional leadership styles. Although diversity in the workforce has the potential to improve performance, research indicates that diversity initiatives must be successfully managed in order to reap these organizational benefits. Human resource practitioners are trained to successfully manage diversity issues to enhance positive outcomes.<sup>60</sup> In an overall sense though, learning how to effectively manage a firm's workforce is increasingly important in that "many companies recognize today, more than ever, their people have become their most critical competitive asset."<sup>61</sup>

Although the lifestyle and workforce changes referenced previously reflect the attitudes and values of the U.S. population, each country is unique with respect to these sociocultural indicators. National cultural values affect behavior in organizations and thus also influence organizational outcomes such as differences in CEO compensation.<sup>62</sup> Likewise, the national culture influences to a large extent the internationalization strategy that firms pursue relative to one's home country.<sup>63</sup> Knowledge sharing is important for dispersing new knowledge in organizations and increasing the speed in implementing innovations. Personal relationships are especially important in China as *guanxi* (personal relationships or good connections) has become a way of doing business within the country and for individuals to advance their careers in what is becoming a more open market society. Understanding the importance of *guanxi* is critical for foreign firms doing business in China.<sup>64</sup>

## 2-3e The Technological Segment

Pervasive and diversified in scope, technological changes affect many parts of societies. These effects occur primarily through new products, processes, and materials. The **technological segment** includes the institutions and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes, and materials.

Given the rapid pace of technological change and risk of disruption, it is vital for firms to thoroughly study the technological segment.<sup>65</sup> The importance of these efforts is suggested

The **technological segment** includes the institutions and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes, and materials.

by the finding that early adopters of new technology often achieve higher market shares and earn higher returns. Thus, both large and small firms should continuously scan the general environment to identify potential substitutes for technologies that are in current use, as well as to identify newly emerging technologies from which their firm could derive competitive advantage.<sup>66</sup>

As a significant technological development, the Internet offers firms a remarkable capability in terms of their efforts to scan, monitor, forecast, and assess conditions in their general environment. Companies continue to study the Internet's capabilities to anticipate how it may allow them to create more value for customers in the future and to anticipate future trends.

Additionally, the Internet generates a significant number of opportunities and threats for firms across the world. Predictions about Internet usage in the years to come are one reason for this. By 2016, the estimate is that there will be 3 billion Internet users globally. This is almost one-half of the world's population. Moreover, "the Internet economy will reach \$4.2 trillion in the G-20 economies. If it were a national economy, the Internet economy would rank in the world's top five, behind only the U.S., China, Japan, and India, and ahead of Germany."<sup>67</sup> Overall, firms can expect that the future is a time period in which the Internet "will have more users (especially in developing markets), more mobile users, more users using various devices throughout the day, and many more people engaged in an increasingly participatory medium."<sup>68</sup>

In spite of the Internet's far-reaching effects and the opportunities and threats associated with its potential, wireless communication technology is becoming a significant technological opportunity for companies to pursue. Handheld devices and other wireless communications equipment are used to access a variety of network-based services. The use of handheld computers with wireless network connectivity, Web-enabled mobile phone handsets, and other emerging platforms (e.g., consumer Internet-access devices such as the iPhone, iPad, and Kindle) has increased substantially and may soon become the dominant form of communication and commerce. In fact, with each new version of these products, additional functionalities and software applications are generating multiple opportunities—and potential threats—for companies of all types.

## 2-3f The Global Segment

The **global segment** includes relevant new global markets, existing markets that are changing, important international political events, and critical cultural and institutional characteristics of global markets.<sup>69</sup> For example, firms competing in the automobile industry must study the global segment. The fact that consumers in multiple nations are willing to buy cars and trucks "from whatever area of the world"<sup>70</sup> supports this position.

When studying the global segment, firms (including automobile manufacturers) should recognize that globalization of business markets may create opportunities to enter new markets as well as threats that new competitors from other economies may also enter their market. In terms of an opportunity for automobile manufacturers, the possibility for these firms to sell their products outside of their home market would seem attractive. But what markets might firms choose to enter? Currently, Brazil, Russia, India, China, and to a lesser extent Indonesia and Malaysia are nations in which automobile and truck sales are expected to increase. In contrast, sales are expected to decline, at least in the near term, in Europe and Japan. These expectations suggest the most and least attractive markets for automobile manufacturers desiring to sell outside their domestic market. At the same time, from the perspective of a threat, Japan, Germany, Korea, Spain, France, and the United States are nations in which there appears to be excess production capacity in the automobile manufacturing industry. In turn, overcapacity signals the possibility that companies based in markets where this is the case will simultaneously attempt to increase their exports as well

The **global segment** includes relevant new global markets, existing markets that are changing, important international political events, and critical cultural and institutional characteristics of global markets.



as sales in their domestic market.<sup>71</sup> Thus, global automobile manufacturers should carefully examine the global segment in order to precisely identify all opportunities and threats.

In light of threats associated with participating in international markets, some firms choose to take a more cautious approach to globalization. These firms participate in what some refer to as *globalfocusing*. Globalfocusing often is used by firms with moderate levels of international operations who increase their internationalization by focusing on global niche markets.<sup>72</sup> This approach allows firms to build on and use their core competencies while limiting their risks within the niche market. Another way in which firms limit their risks in international markets is to focus their operations and sales in one region of the world.<sup>73</sup> Success with these efforts finds a firm building relationships in and knowledge of its markets. As the firm builds these strengths, rivals find it more difficult to enter its markets and compete successfully.

Firms competing in global markets should recognize each market's sociocultural and institutional attributes. For example, Korean ideology emphasizes communitarianism, a characteristic of many Asian countries. Alternatively, the ideology in China calls for an emphasis on *guanxi*—personal connections—while in Japan, the focus is on *wa*, or group harmony and social cohesion.<sup>74</sup> The institutional context of China suggests a major emphasis on centralized planning by the government. The Chinese government provides incentives to firms to develop alliances with foreign firms having sophisticated technology in hopes of building knowledge and introducing new technologies to the Chinese markets over time.<sup>75</sup> As such, it is important to analyze the strategic intent of foreign firms when pursuing alliances and joint ventures abroad, especially where the local partners are receiving technology which may in the long run reduce the foreign firms' advantages.<sup>76</sup>

Increasingly, the *informal economy* as it exists throughout the world is another aspect of the global segment requiring analysis. Growing in size, this economy has implications for firms' competitive actions and responses in that increasingly firms competing in the formal economy (defined in the Strategic Focus) will find that they are competing against informal economy companies as well. We provide additional insights about the informal economy in the Strategic Focus.

Learn more about Spain's  
Informal Economy.  
[www.cengagebrain.com](http://www.cengagebrain.com)

## 2-3g The Physical Environment Segment

The **physical environment segment** refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to and deal with those changes.<sup>77</sup> Concerned with trends oriented to sustaining the world's physical environment, firms recognize that ecological, social, and economic systems interactively influence what happens in this particular segment and that they are part of an interconnected global society.<sup>78</sup>

Companies across the globe are concerned about the physical environment and many record the actions they are taking in reports with names such as "Sustainability" and "Corporate Social Responsibility." Moreover and in a comprehensive sense, an increasing number of companies are interested in sustainable development, which is "the development that meets the needs of the present without compromising the ability of future generations to meet their own needs."<sup>79</sup>

There are many parts or attributes of the physical environment that firms consider as they try to identify trends in the physical environment segment.<sup>80</sup> For example, McDonald's seeks to become a sustainable influence on the global food industry. Receiving certification from the Marine Stewardship Council (MSC) for its U.S. supply signals that the company is sourcing fish from "suppliers that follow strict MSC standards for ecosystem impact, management, and health of fish stock."<sup>81</sup> As the world's largest retailer, Walmart's environmental footprint is huge, meaning that trends in the physical environment can significantly affect this firm and how it chooses to operate. Perhaps in light of trends occurring in the physical environment, Walmart has announced that its goal is to produce zero waste and to use 100 percent renewable energy to power its operations.<sup>82</sup>

The **physical environment segment** refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to and deal with those changes.



## Strategic Focus

## GLOBALIZATION

### The Informal Economy: What It Is and Why It Is Important

The informal economy refers to commercial activities that occur at least partly outside a governing body's observation, taxation, and regulation. In slightly different words, sociologists Manuel Castells and Alejandro Portes suggest that the "informal economy is characterized by one central feature: it is unregulated by the institutions of society in a legal and social environment in which similar activities are regulated." Firms located in the informal economy are typically thought of as businesses that are unregistered but that are producing and selling legal products. In contrast to the informal economy, the formal economy is comprised of commercial activities that a governing body taxes and monitors for society's benefit and whose outputs are included in a country's gross domestic product.

For some, working in the informal economy is a choice, such as is the case when individuals decide to supplement the income they are earning through employment in the formal economy with a second job in the informal economy. However, for most people working in the informal economy is a necessity rather than a choice—a reality that contributes to the informal economy's size and significance. Although generalizing about the quality of informal employment is difficult, evidence suggests that it typically means poor employment conditions and greater poverty for workers.

Estimates of the informal economy's size across countries and regions vary. In developing countries, the informal economy accounts for as much as three-quarters of all nonagricultural employment, and perhaps as much as 90 percent in some countries in South Asia and sub-Saharan Africa. But the informal economy is also prominent in developed countries such as Finland, Germany, and France (where this economy is estimated to account for 18.3 percent, 16.3 percent, and 15.3 percent, respectively, of these nations' total economic activity). In the United States, recent estimates are that the informal economy is now generating as much as \$2 trillion in economic activity on an annual basis. This is double the size of the U.S. informal economy

in 2009. In terms of the number of people working in an informal economy, we can consider the suggestion that "India's informal economy... (includes) hundreds of millions of shopkeepers, farmers, construction workers, taxi drivers, street vendors, rag pickers, tailors, repairmen, middlemen, black marketers and more."

There are various causes of the informal economy's growth, including an inability of a nation's economic environment to create a significant number of jobs relative to available workers. This has been a particularly acute problem during the recent global recession. In the words of a person living in Spain: "Without the underground (informal) economy, we would be in a situation of probably violent social unrest." Governments' inability to facilitate growth efforts in their nation's economic environment is another issue. In this regard, another Spanish citizen suggests that "What the government should focus on is reforming the formal economy to make it more efficient and competitive."

In a general sense, the informal economy yields threats and opportunities for formal economy firms. One threat is that informal businesses may have a cost advantage when competing against formal economy firms in that they do not pay taxes or incur the costs of regulations. But the informal economy surfaces opportunities as well. For example, formal economy firms can try to understand the needs of customers that informal economy firms are satisfying and then find ways to better meet their needs. Another valuable opportunity is to attract some of the informal economy's talented human capital to accept positions of employment in formal economy firms.

Sources: A. Picchi, 2013, A shadow economy may be keeping the US afloat, *MSN Money*, [www.msn.com](http://www.msn.com), May 3; 2013, Meeting on informal economy statistics: Country experience, international recommendations, and application, *United Nations Economic Commission for Africa*, [www.uneca.org](http://www.uneca.org), April; 2013, About the informal economy, *Women in informal employment: Globalizing and organizing*, [www.wiego.org](http://www.wiego.org), May; G. Bruton, R. D. Ireland, & D. J. Ketchen, Jr., 2012, Toward a research agenda on the informal economy, *Academy of Management Perspectives*, 26(3): 1–11; R. D. Ireland, 2012, 2012 program theme: The informal economy, *Academy of Management*, [www.meeting.aomonline.org](http://www.meeting.aomonline.org), March; R. Minder, 2012, In Spain, jobless find a refuge off the books, *New York Times*, [www.nytimes.com](http://www.nytimes.com), May 18.

As our discussion of the general environment shows, identifying anticipated changes and trends among segments and their elements is a key objective of analyzing this environment. With a focus on the future, the analysis of the general environment allows firms to identify opportunities and threats. It is necessary to have a top management team with the experience, knowledge, and sensitivity required to effectively analyze a firm's general environment.<sup>83</sup> Also critical to a firm's choices of strategies and their associated competitive

actions and responses is an understanding of its industry environment and its competitors; next, we discuss the analyses firms complete to gain such an understanding.

## 2-4 Industry Environment Analysis

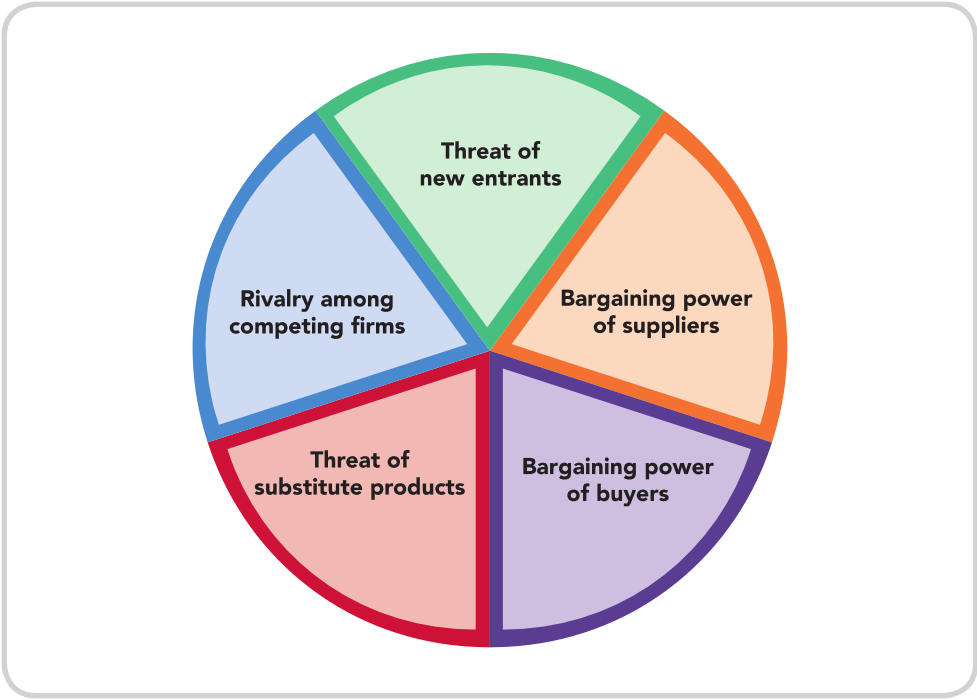
An **industry** is a group of firms producing products that are close substitutes. In the course of competition, these firms influence one another. Typically, companies use a rich mix of different competitive strategies to pursue above-average returns when competing in a particular industry. An industry's structural characteristics influence a firm's choice of strategies.<sup>84</sup>

Compared with the general environment, the industry environment (measured primarily in the form of its characteristics) has a more direct effect on the competitive actions and responses a firm takes to succeed.<sup>85</sup> To study an industry, the firm examines five forces that affect the ability of all firms to operate profitably within a given industry. Shown in Figure 2.2, the five forces are: the threats posed by new entrants, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors.

The five forces of competition model depicted in Figure 2.2 expands the scope of a firm's competitive analysis. Historically, when studying the competitive environment, firms concentrated on companies with which they directly competed. However, firms must search more broadly to recognize current and potential competitors by identifying potential customers as well as the firms serving them. For example, the communications industry is now broadly defined as encompassing media companies, telecoms, entertainment companies, and companies producing devices such as smartphones.<sup>86</sup> In such an environment, firms must study many other industries to identify companies with capabilities (especially technology-based capabilities) that might be the foundation for producing a good or a service that can compete against what they are producing.

When studying the industry environment, firms must also recognize that suppliers can become a firm's competitors (by integrating forward) as can buyers (by integrating

**Figure 2.2** The Five Forces of Competition Model



An **industry** is a group of firms producing products that are close substitutes.

backward). For example, several firms have integrated forward in the pharmaceutical industry by acquiring distributors or wholesalers. In addition, firms choosing to enter a new market and those producing products that are adequate substitutes for existing products can become a company's competitors.

Next, we examine the five forces the firm analyzes to understand the profitability potential within an industry (or a segment of an industry) in which it competes or may choose to compete.

## 2-4a Threat of New Entrants

Identifying new entrants is important because they can threaten the market share of existing competitors.<sup>87</sup> One reason new entrants pose such a threat is that they bring additional production capacity. Unless the demand for a good or service is increasing, additional capacity holds consumers' costs down, resulting in less revenue and lower returns for competing firms. Often, new entrants have a keen interest in gaining a large market share. As a result, new competitors may force existing firms to be more efficient and to learn how to compete in new dimensions (e.g., using an Internet-based distribution channel).

The likelihood that firms will enter an industry is a function of two factors: barriers to entry and the retaliation expected from current industry participants. Entry barriers make it difficult for new firms to enter an industry and often place them at a competitive disadvantage even when they are able to enter. As such, high entry barriers tend to increase the returns for existing firms in the industry and may allow some firms to dominate the industry.<sup>88</sup> Thus, firms competing successfully in an industry want to maintain high entry barriers in order to discourage potential competitors from deciding to enter the industry.

### Barriers to Entry

Firms competing in an industry (and especially those earning above-average returns) try to develop entry barriers to thwart potential competitors. In general, more is known about entry barriers (with respect to how they are developed as well as paths firms can pursue to overcome them) in industrialized countries such as those in North America and Western Europe. In contrast, relatively little is known about barriers to entry in the rapidly emerging markets such as those in China. However, recent research suggests that Chinese executives perceive that advertising effects are the most significant of seven barriers to China while capital requirements are viewed as the least important.<sup>89</sup>

There are different kinds of barriers to entering a market that firms study when examining an industry environment. Companies competing within a particular industry study these barriers to determine the degree to which their competitive position reduces the likelihood of new competitors being able to enter the industry for the purpose of competing against them. Firms considering entering an industry study entry barriers to determine the likelihood of being able to identify an attractive competitive position within the industry being analyzed. Next, we discuss several significant entry barriers that may discourage competitors from entering a market and that may facilitate a firm's ability to remain competitive in a market in which it currently competes.

**Economies of Scale** *Economies of scale* are derived from incremental efficiency improvements through experience as a firm grows larger. Therefore, the cost of producing each unit declines as the quantity of a product produced during a given period increases. A new entrant is unlikely to quickly generate the level of demand for its product that in turn would allow it to develop economies of scale.

Economies of scale can be developed in most business functions, such as marketing, manufacturing, research and development, and purchasing.<sup>90</sup> Firms sometimes form strategic alliances or joint ventures to gain scale economies. This is the case for Mitsubishi Heavy Industries Ltd. and Hitachi Ltd., as these companies "merged their operations for fossil-fuel-based power systems into a joint venture aimed at gaining scale to compete against global rivals."<sup>91</sup>

Becoming more flexible in terms of being able to meet shifts in customer demand is another benefit for an industry incumbent and another possible entry barrier for the firm thinking of entering an industry. For example, a firm may choose to reduce its price with the intention of capturing a larger share of the market. Alternatively, it may keep its price constant to increase profits. In so doing, it likely will increase its free cash flow, which is very helpful during financially challenging times.

Some competitive conditions reduce the ability of economies of scale to create an entry barrier. Many companies now customize their products for large numbers of small customer groups. In these cases, customized products are not manufactured in the volumes necessary to achieve economies of scale. Customization is made possible by several factors including flexible manufacturing systems (this point is discussed further in Chapter 4). In fact, the new manufacturing technology facilitated by advanced information systems has allowed the development of mass customization in an increasing number of industries. Although it is not appropriate for all products and implementing it can be challenging, mass customization has become increasingly common in manufacturing products.<sup>92</sup> Online ordering has enhanced customers' ability to buy customized products. Companies manufacturing customized products learn how to respond quickly to customers' needs in lieu of developing scale economies.

**Product Differentiation** Over time, customers may come to believe that a firm's product is unique. This belief can result from the firm's service to the customer, effective advertising campaigns, or being the first to market a good or service. Greater levels of perceived product uniqueness create customers who consistently purchase a firm's products. To combat the perception of uniqueness, new entrants frequently offer products at lower prices. This decision, however, may result in lower profits or even losses.

As noted in the Opening Case, Coca-Cola Company and PepsiCo have established strong brands in the markets in which they compete, and these companies compete against each other in countries throughout the world. Because each of these competitors has allocated a significant amount of resources over many decades to build its brands, customer loyalty is strong for each firm. When considering entry into the soft drink market, a potential entrant would be well advised to pause to determine actions it would take for the purpose of trying to overcome the brand image and consumer loyalty each of these giants possess.

**Capital Requirements** Competing in a new industry requires a firm to have resources to invest. In addition to physical facilities, capital is needed for inventories, marketing activities, and other critical business functions. Even when a new industry is attractive, the capital required for successful market entry may not be available to pursue the market opportunity.<sup>93</sup> For example, defense industries are difficult to enter because of the substantial resource investments required to be competitive. In addition, because of the high knowledge requirements of the defense industry, a firm might acquire an existing company as a means of entering this industry, but it must have access to the capital necessary to do this.

**Switching Costs** Switching costs are the one-time costs customers incur when they buy from a different supplier. The costs of buying new ancillary equipment and of retraining employees, and even the psychic costs of ending a relationship, may be incurred in switching to a new supplier. In some cases, switching costs are low, such as when the consumer switches to a different brand of soft drink. Switching costs can vary as a function of time as shown by the fact that in terms of credit hours toward graduation, the cost to a student to transfer from one university to another as a freshman is much lower than it is when the student is entering the senior year.

Occasionally, a decision made by manufacturers to produce a new, innovative product creates high switching costs for customers. Customer loyalty programs, such as airlines' frequent flyer miles, are intended to increase the customer's switching costs. If switching costs



are high, a new entrant must offer either a substantially lower price or a much better product to attract buyers. Usually, the more established the relationships between parties, the greater the switching costs.

**Access to Distribution Channels** Over time, industry participants commonly learn how to effectively distribute their products. Once a relationship with its distributors has been built a firm will nurture it, thus creating switching costs for the distributors. Access to distribution channels can be a strong entry barrier for new entrants, particularly in consumer nondurable goods industries (e.g., in grocery stores where shelf space is limited) and in international markets. New entrants have to persuade distributors to carry their products, either in addition to or in place of those currently distributed. Price breaks and cooperative advertising allowances may be used for this purpose; however, those practices reduce the new entrant's profit potential. Interestingly, access to distribution is less of a barrier for products that can be sold on the Internet.

**Cost Disadvantages Independent of Scale** Sometimes, established competitors have cost advantages that new entrants cannot duplicate. Proprietary product technology, favorable access to raw materials, desirable locations, and government subsidies are examples. Successful competition requires new entrants to reduce the strategic relevance of these factors. For example, delivering purchases directly to the buyer can counter the advantage of a desirable location; new food establishments in an undesirable location often follow this practice. Zara is owned by Inditex, the largest fashion clothing retailer in the world.<sup>94</sup> From the time of its launching, Spanish clothing company Zara relied on classy, well-tailored, and relatively inexpensive items that were produced and sold by adhering to ethical practices to successfully enter the highly competitive global clothing market and overcome that market's entry barriers.<sup>95</sup>

**Government Policy** Through their decisions about issues such as the granting of licenses and permits, governments can also control entry into an industry. Liquor retailing, radio and TV broadcasting, banking, and trucking are examples of industries in which government decisions and actions affect entry possibilities. Also, governments often restrict entry into some industries because of the need to provide quality service or the desire to protect jobs. Alternatively, deregulating industries such as the airline and utilities industries in the United States, generally results in additional firms choosing to enter and compete within an industry.<sup>96</sup> Governmental decisions and policies regarding antitrust issues also affect entry barriers. For example, in the United States, the Antitrust Division of the Justice Department or the Federal Trade Commission will sometimes disallow a proposed merger because officials conclude that approving it would create a firm that is too dominant in an industry and would thus create unfair competition.<sup>97</sup> Such a negative ruling would obviously be an entry barrier for an acquiring firm.

### Expected Retaliation

Companies seeking to enter an industry also anticipate the reactions of firms in the industry. An expectation of swift and vigorous competitive responses reduces the likelihood of entry. Vigorous retaliation can be expected when the existing firm has a major stake in the



*The Naked Grocer provides boxes of assorted, locally sourced vegetables to order. By offering locally-sourced produce the company is trying to reduce the strategic relevance of advantages possessed by established firms.*

industry (e.g., it has fixed assets with few, if any, alternative uses), when it has substantial resources, and when industry growth is slow or constrained. For example, any firm attempting to enter the airline industry can expect significant retaliation from existing competitors due to overcapacity.

Locating market niches not being served by incumbents allows the new entrant to avoid entry barriers. Small entrepreneurial firms are generally best suited for identifying and serving neglected market segments. When Honda first entered the U.S. motorcycle market, it concentrated on small-engine motorcycles, a market that firms such as Harley-Davidson ignored. By targeting this neglected niche, Honda initially avoided a significant amount of head-to-head competition with well-established competitors. After consolidating its position, Honda used its strength to attack rivals by introducing larger motorcycles and competing in the broader market.

## 2-4b Bargaining Power of Suppliers

Increasing prices and reducing the quality of their products are potential means suppliers use to exert power over firms competing within an industry. If a firm is unable to recover cost increases by its suppliers through its own pricing structure, its profitability is reduced by its suppliers' actions. A supplier group is powerful when

- It is dominated by a few large companies and is more concentrated than the industry to which it sells.
- Satisfactory substitute products are not available to industry firms.
- Industry firms are not a significant customer for the supplier group.
- Suppliers' goods are critical to buyers' marketplace success.
- The effectiveness of suppliers' products has created high switching costs for industry firms.
- It poses a credible threat to integrate forward into the buyers' industry. Credibility is enhanced when suppliers have substantial resources and provide a highly differentiated product.

The airline industry is one in which suppliers' bargaining power is changing. Though the number of suppliers is low, the demand for major aircraft is also relatively low. Boeing and Airbus aggressively compete for orders of major aircraft, creating more power for buyers in the process. When a large airline signals that it might place a "significant" order for wide-body airliners that either Airbus or Boeing might produce, both companies are likely to battle for the business and include a financing arrangement, highlighting the buyer's power in the potential transaction.

## 2-4c Bargaining Power of Buyers

Firms seek to maximize the return on their invested capital. Alternatively, buyers (customers of an industry or a firm) want to buy products at the lowest possible price—the point at which the industry earns the lowest acceptable rate of return on its invested capital. To reduce their costs, buyers bargain for higher quality, greater levels of service, and lower prices.<sup>98</sup> These outcomes are achieved by encouraging competitive battles among the industry's firms. Customers (buyer groups) are powerful when

- They purchase a large portion of an industry's total output.
- The sales of the product being purchased account for a significant portion of the seller's annual revenues.
- They could switch to another product at little, if any, cost.
- The industry's products are undifferentiated or standardized, and the buyers pose a credible threat if they were to integrate backward into the sellers' industry.

Consumers armed with greater amounts of information about the manufacturer's costs and the power of the Internet as a shopping and distribution alternative have increased bargaining power in many industries.

## 2-4d Threat of Substitute Products

Substitute products are goods or services from outside a given industry that perform similar or the same functions as a product that the industry produces. For example, as a sugar substitute, NutraSweet (and other sugar substitutes) places an upper limit on sugar manufacturers' prices—NutraSweet and sugar perform the same function, though with different characteristics. Other product substitutes include e-mail and fax machines instead of overnight deliveries, plastic containers rather than glass jars, and tea instead of coffee.

Newspaper firms have experienced significant circulation declines over the past decade or more. The declines are a result of the ready availability of substitute outlets for news including Internet sources, cable television news channels, and e-mail and cell phone alerts. Likewise, satellite TV and cable and telecommunication companies provide substitute services for basic media services such as television, Internet, and phone. Tablets such as the iPad are reducing the number of PCs sold as suggested by the fact that worldwide shipments of PCs declined 14 percent during the first quarter of 2013 compared to the same quarter a year earlier. At the same time, "tablets like Apple's iPad flew off the shelves."<sup>99</sup>

In general, product substitutes present a strong threat to a firm when customers face few if any switching costs and when the substitute product's price is lower or its quality and performance capabilities are equal to or greater than those of the competing product. Differentiating a product along dimensions that are valuable to customers (such as quality, service after the sale, and location) reduces a substitute's attractiveness.



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## 2-4e Intensity of Rivalry among Competitors

Because an industry's firms are mutually dependent, actions taken by one company usually invite responses. In many industries, firms actively compete against one another. Competitive rivalry intensifies when a firm is challenged by a competitor's actions or when a company recognizes an opportunity to improve its market position.

Firms within industries are rarely homogeneous; they differ in resources and capabilities and seek to differentiate themselves from competitors. Typically, firms seek to differentiate their products from competitors' offerings in ways that customers value and in which the firms have a competitive advantage. Common dimensions on which rivalry is based include price, service after the sale, and innovation.

Next, we discuss the most prominent factors that experience shows affect the intensity of rivalries among firms.

### Numerous or Equally Balanced Competitors

Intense rivalries are common in industries with many companies. With multiple competitors, it is common for a few firms to believe they can act without eliciting a response. However, evidence suggests that other firms generally are aware of competitors' actions, often choosing to respond to them. At the other extreme, industries with only a few firms of equivalent size and power also tend to have strong rivalries. The large and often similar-sized resource bases of these firms permit vigorous actions and responses. The competitive battles between Airbus and Boeing exemplify intense rivalry between relatively equal competitors, especially as airlines place bids for the new wide-body planes they are producing. As discussed in the Opening Case, Coca-Cola Company and PepsiCo have a strong rivalry in an array of liquid drinks as consumers demand great taste and real health benefits.<sup>100</sup>

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### Slow Industry Growth

When a market is growing, firms try to effectively use resources to serve an expanding customer base. Markets increasing in size reduce the pressure to take customers from competitors. However, rivalry in no-growth or slow-growth markets becomes more intense as firms battle to increase their market shares by attracting competitors' customers. Certainly, this has been the case in the fast-food industry as McDonald's, Wendy's, and Burger King use their resources, capabilities, and core competencies to try to win each other's customers.<sup>101</sup> The instability in the market that results from these competitive engagements may reduce the profitability for all firms engaging in such battles.

### High Fixed Costs or High Storage Costs

When fixed costs account for a large part of total costs, companies try to maximize the use of their productive capacity. Doing so allows the firm to spread costs across a larger volume of output. However, when many firms attempt to maximize their productive capacity, excess capacity is created on an industry-wide basis. To then reduce inventories, individual companies typically cut the price of their product and offer rebates and other special discounts to customers. However, doing this often intensifies competition. The pattern of excess capacity at the industry level followed by intense rivalry at the firm level is frequently observed in industries with high storage costs. Perishable products, for example, lose their value rapidly with the passage of time. As their inventories grow, producers of perishable goods often use pricing strategies to sell products quickly.

### Lack of Differentiation or Low Switching Costs

When buyers find a differentiated product that satisfies their needs, they frequently purchase the product loyally over time. Industries with many companies that have successfully differentiated their products have less rivalry, resulting in lower competition for individual firms. Firms that develop and sustain a differentiated product that cannot be easily imitated by competitors often earn higher returns. However, when buyers view products as commodities (i.e., as products with few differentiated features or capabilities), rivalry intensifies. In these instances, buyers' purchasing decisions are based primarily on price and, to a lesser degree, service. Personal computers are a commodity product and the cost to switch from a computer manufactured by one firm to another is low. Thus, the rivalry among Dell, Hewlett-Packard, Lenovo, and other computer manufacturers is strong as these companies consistently seek to find ways to differentiate their offerings.

### High Strategic Stakes

Competitive rivalry is likely to be high when it is important for several of the competitors to perform well in the market. Competing in diverse businesses (such as semiconductors, petrochemicals, fashion, medicine, and skyscraper and plant construction, among others), Samsung has now become a formidable foe for Apple in the global smartphone market. Samsung has committed a significant amount of resources to develop innovative products as the foundation for its efforts to try to outperform Apple in selling this particular product. The fact that the end of the first quarter of 2013 found Samsung holding 33 percent of the global smartphone market compared to an 18 percent share for Apple seemed to suggest that the firm's commitment was yielding desirable outcomes.<sup>102</sup> However, this market is extremely important to Apple as well, suggesting that the smartphone rivalry between these two firms (along with others) will remain quite intense.

High strategic stakes can also exist in terms of geographic locations. For example, a number of automobile manufacturers have committed or are committing to establishing manufacturing facilities in China, which has been the world's largest car market since 2009.<sup>103</sup> General Motors recently announced that it received permission from Chinese authorities



to build an 8 billion yuan (\$1.3 billion) factory to manufacture its Cadillac brand. The Shanghai GM joint venture is to build this facility.<sup>104</sup> Because of the high stakes involved in China for both General Motors and other firms producing luxury cars (including Audi, BMW, and Mercedes-Benz), rivalry among these firms in this market is quite intense.

### High Exit Barriers

Sometimes companies continue competing in an industry even though the returns on their invested capital are low or negative. Firms making this choice likely face high exit barriers, which include economic, strategic, and emotional factors causing them to remain in an industry when the profitability of doing so is questionable.

Exit barriers are especially high in the airline industry. Profitability in this industry has been very difficult to achieve since the start of the latest global financial crisis (beginning in roughly late 2007 or early 2008). However, profits in the airline industry were expected to increase by approximately 40 percent in 2013 compared to 2012. Industry consolidation and efficiency enhancements to how airline alliances integrate their activities helped reduce airline companies' costs while improving economic conditions in a number of countries. This resulted in a greater demand for travel. These are positive signs, at least in the short run, for these firms given that they do indeed face very high barriers if they were to contemplate leaving the airline travel industry.<sup>105</sup> Common exit barriers that firms face include the following:

- Specialized assets (assets with values linked to a particular business or location)
- Fixed costs of exit (such as labor agreements)
- Strategic interrelationships (relationships of mutual dependence, such as those between one business and other parts of a company's operations, including shared facilities and access to financial markets)
- Emotional barriers (aversion to economically justified business decisions because of fear for one's own career, loyalty to employees, and so forth)
- Government and social restrictions (often based on government concerns for job losses and regional economic effects; more common outside the United States).

## 2-5 Interpreting Industry Analyses

Effective industry analyses are products of careful study and interpretation of data and information from multiple sources. A wealth of industry-specific data is available for firms to analyze for the purpose of better understanding an industry's competitive realities. Because of globalization, international markets and rivalries must be included in the firm's analyses. And, because of the development of global markets, a country's borders no longer restrict industry structures. In fact, in general, entering international markets enhances the chances of success for new ventures as well as more established firms.<sup>106</sup>

Analysis of the five forces within a given industry allows the firm to determine the industry's attractiveness in terms of the potential to earn average or above-average returns. In general, the stronger the competitive forces, the lower the potential for firms to generate profits by implementing their strategies. An unattractive industry has low entry barriers, suppliers and buyers with strong bargaining positions, strong competitive threats from product substitutes, and intense rivalry among competitors. These industry characteristics make it difficult for firms to achieve strategic competitiveness and earn above-average returns. Alternatively, an attractive industry has high entry barriers, suppliers and buyers with little bargaining power, few competitive threats from product substitutes, and relatively moderate rivalry.<sup>107</sup> Next, we explain strategic groups as an aspect of industry competition.

## 2-6 Strategic Groups

A set of firms emphasizing similar strategic dimensions and using a similar strategy is called a **strategic group**.<sup>108</sup> The competition between firms within a strategic group is greater than the competition between a member of a strategic group and companies outside that strategic group. Therefore, intra-strategic group competition is more intense than is inter-strategic group competition. In fact, more heterogeneity is evident in the performance of firms within strategic groups than across the groups. The performance leaders within groups are able to follow strategies similar to those of other firms in the group and yet maintain strategic distinctiveness as a foundation for earning above-average returns.<sup>109</sup>

The extent of technological leadership, product quality, pricing policies, distribution channels, and customer service are examples of strategic dimensions that firms in a strategic group may treat similarly. Thus, membership in a particular strategic group defines the essential characteristics of the firm's strategy.<sup>110</sup>

The notion of strategic groups can be useful for analyzing an industry's competitive structure. Such analyses can be helpful in diagnosing competition, positioning, and the profitability of firms competing within an industry.<sup>111</sup> High mobility barriers, high rivalry, and low resources among the firms within an industry limit the formation of strategic groups.<sup>112</sup> However, after strategic groups are formed, their membership remains relatively stable over time.<sup>113</sup> Using strategic groups to understand an industry's competitive structure requires the firm to plot companies' competitive actions and responses along strategic dimensions such as pricing decisions, product quality, distribution channels, and so forth. This type of analysis shows the firm how certain companies are competing similarly in terms of how they use similar strategic dimensions.

Strategic groups have several implications. First, because firms within a group offer similar products to the same customers, the competitive rivalry among them can be intense. The more intense the rivalry, the greater the threat to each firm's profitability. Second, the strengths of the five forces differ across strategic groups. Third, the closer the strategic groups are in terms of their strategies, the greater is the likelihood of rivalry between the groups.

German-based car manufacturers Audi (a part of the Volkswagen group), Bayerische Motoren Werke AG (BMW), and Daimler-Benz (Mercedes-Benz) implement similar strategies (based on the differentiation business-level strategy), emphasize similar strategic dimensions, and compete aggressively against each other. These three firms constitute a strategic group (in the performance/luxury segment) as do Maruti-Suzuki, Tata Motors, and Skoda (these three firms form a passenger car strategic group with the distinctive feature that they sell their products primarily in their domestic markets and very little internationally). We describe the strategic group featuring the three German companies in the Strategic Focus.

## 2-7 Competitor Analysis

The competitor environment is the final part of the external environment requiring study. Competitor analysis focuses on each company against which a firm competes directly. Coca-Cola Company and PepsiCo, Home Depot and Lowe's, Carrefour SA and Tesco PLC, and Boeing and Airbus are examples of competitors who are keenly interested in understanding each other's objectives, strategies, assumptions, and capabilities. Indeed, intense rivalry creates a strong need to understand competitors.<sup>114</sup> In a competitor analysis, the firm seeks to understand the following:

- What drives the competitor, as shown by its *future objectives*
- What the competitor is doing and can do, as revealed by its *current strategy*

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A set of firms emphasizing similar strategic dimensions and using a similar strategy is called a **strategic group**.

## Strategic Focus

## GLOBALIZATION

### German Performance/Luxury Cars: If You Have Seen One, Have You Seen Them All?

Audi, BMW, and Mercedes-Benz (Mercedes) have long competed against each other in the performance/luxury segment of the automobile industry. Given that they implement similar strategies in many of the same markets throughout the world and emphasize similar dimensions to do so, these firms form a strategic group. This means that the rivalry within this group is more intense than is the rivalry between members of this group and companies offering products that are intended to functionally serve and satisfy a mass-market appeal among large customer groups. One could even argue that three sub-strategic groups exist for these firms in that each offers products in the large, mid-size, and small parts of the performance/luxury segment. (Think of the Audi S8 versus the BMW 7 series versus the S Mercedes series as products through which these firms compete against each other in terms of large performance/luxury cars.)

The similarities among these firms as they compete are extensive. For example, the Chinese and U.S. markets are critical to their success. With respect to China, an analyst recently noted that "BMW, Audi and Daimler's Mercedes-Benz units have benefited as China's fast-growing wealthy population has flocked to high-end cars in recent years." In response to this growth in demand for their products, all three firms are investing billions of dollars to expand production and their sales operations in China.

For the U.S. market, the firms are introducing new models that are intended to significantly expand their sales. One way these competitors are doing this is to offer "lower priced models that would draw younger, less affluent U.S. customers away from mass market brands such as Ford Motor Co., Honda Motor Co., and Toyota Motor Corp." A lower-cost version of the A3 sedan is Audi's initial offering to reach this objective. BMW has developed a new version of its top-selling 3 series sedan (the 320) that will have a base price roughly \$4,000 below the currently least expensive car in this series. Similarly, Mercedes intends to offer the CLA, which is a 4-cylinder car with a base price just below \$30,000. Essentially, introducing these products is a strong attempt by the three firms to lower price as an entry barrier to their products among consumers in their 20s, 30s, and early 40s.

These firms are emphasizing similar dimensions or product features to produce these new models as well as some existing ones. For example, diesel engines are important to the companies and their efforts to sell more cars in China, the United



*The 2014 CLA 45 AMG Mercedes-Benz is presented at the New York International Auto Show in New York's Javits Center in March 2013. The new addition to Mercedes-Benz' product mix is aimed at customers typically targeted by mass market brands.*

States, and other countries as well. Because of this, the three of them recently joined a few other companies to develop a Web site ([www.clearlybetterdiesel.org](http://www.clearlybetterdiesel.org)) that touts diesel's benefits of superior fuel economy and a reduced environmental impact. To better serve the needs of younger consumers, all three companies are "re-thinking everything from dashboard entertainment systems to the relative importance of mileage over horsepower to fundamental marketing strategies." An initial outcome from these evaluation processes is a decision to include smartly presented, smartphone-driven multimedia systems in models being developed for the U.S. market.

As is often the case with strategic groups, the one among Audi, BMW, and Mercedes has remained stable over the years. As such, we can anticipate that the rivalry among them will remain intense as they rely on similar strategic dimensions to implement similar strategies.

Sources: C. Carroll, 2013, Audi plans to attract more U.S. buyers with diesels, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), February 8; V. Fuhrmans, 2013, Europe bets U.S. auto demand to stay high, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), January 16; V. Fuhrmans, 2013, German auto makers to shake up luxury market, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), January 14; V. Fuhrmans & F. Geiger, 2013, VW to bolster its output in China, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), March 14; F. Geiger, 2013, Daimler boosts investment in China, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), February 1; J. W. White, 2013, Beyond boomer buyers: Car makers seek younger crop of customers, *Wall Street Journal*, [www.wsj.com](http://www.wsj.com), January 16.

- What the competitor believes about the industry, as shown by its *assumptions*
- What the competitor's capabilities are, as shown by its *strengths* and *weaknesses*.<sup>115</sup>

Knowledge about these four dimensions helps the firm prepare an anticipated response profile for each competitor (see Figure 2.3). The results of an effective competitor analysis help a firm understand, interpret, and predict its competitors' actions and responses. Understanding competitors' actions and responses clearly contributes to the firm's ability to compete successfully within the industry.<sup>116</sup> Interestingly, research suggests that executives often fail to analyze competitors' possible reactions to competitive actions their firm takes,<sup>117</sup> placing their firm at a potential competitive disadvantage as a result.

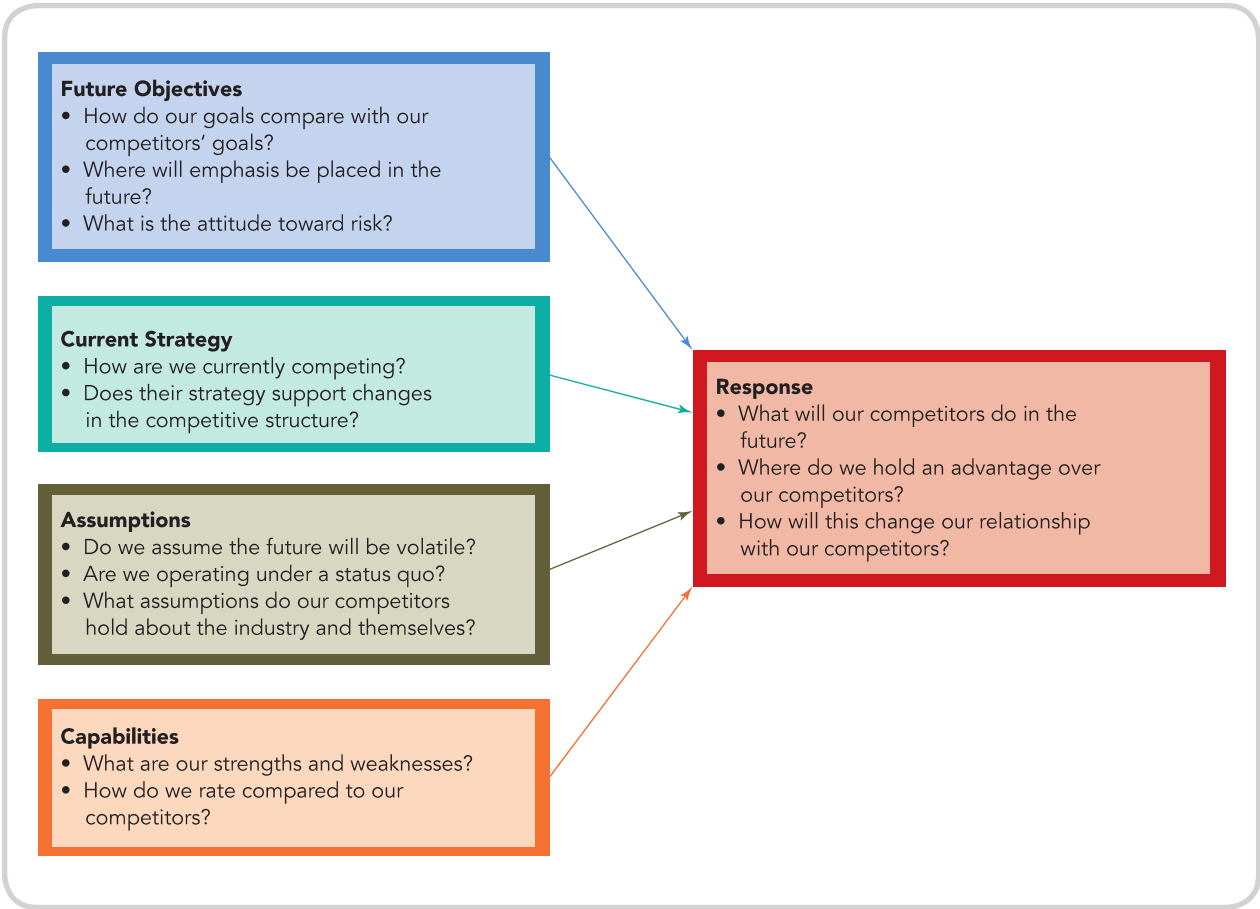
Critical to an effective competitor analysis is gathering data and information that can help the firm understand its competitors' intentions and the strategic implications resulting from them.<sup>118</sup> Useful data and information combine to form **competitor intelligence**, the set of data and information the firm gathers to better understand and anticipate competitors' objectives, strategies, assumptions, and capabilities. In competitor analysis, the firm gathers intelligence not only about its competitors, but also regarding public policies in countries around the world. Such intelligence facilitates an understanding of the strategic posture of foreign competitors. Through effective competitive and public policy intelligence, the firm gains the insights needed to make effective strategic decisions regarding how to compete against rivals.

When asked to describe competitive intelligence, phrases such as "competitive spying" and "corporate espionage" come to my mind for some. These phrases denote the fact that

**Competitor intelligence**

is the set of data and information the firm gathers to better understand and anticipate competitors' objectives, strategies, assumptions, and capabilities.

Figure 2.3 Competitor Analysis Components





competitive intelligence is an activity that appears to involve trade-offs.<sup>119</sup> The reason for this is that “what is ethical in one country is different from what is ethical in other countries.” This position implies that the rules of engagement to follow when gathering competitive intelligence change in different contexts.<sup>120</sup> However, firms avoid the possibility of legal entanglements and ethical quandaries only when their competitive intelligence gathering methods are governed by a strict set of legal and ethical guidelines.<sup>121</sup> This means that ethical behavior and actions as well as the mandates of relevant laws and regulations should be the foundation on which a firm’s competitive intelligence-gathering process is formed.

When gathering competitive intelligence, firms must also pay attention to the complementors of its products and strategy.<sup>122</sup> **Complementors** are companies or networks of companies that sell goods or services that are compatible with the focal firm’s good or service. When a complementor’s good or service contributes to the functionality of a focal firm’s good or service, it in turn creates additional value for that firm.

There are many examples of firms whose good or service complements other companies’ offerings. For example, firms manufacturing affordable home photo printers complement other companies’ efforts to sell digital cameras. Intel and Microsoft are perhaps the most widely recognized complementors. The Microsoft slogan “Intel Inside” demonstrates the relationship between two firms who do not directly buy from or sell to each other but whose products have a strong complementary relationship. Gasoline and automobiles are obvious complementors in that gasoline-powered cars are useless without gas while the price of gasoline would decline significantly without cars.

Alliances among airline companies such as Oneworld and Star find member companies sharing their route structures and customer loyalty programs as a means of complementing each other’s operations. (Alliances and other cooperative strategies are described in Chapter 9.) In the example we are considering here, each of the two alliances is a network of complementors. American Airlines, British Airways, Finnair, Japan Airlines, and Royal Jordanian are among the airlines forming the Oneworld alliance. Air Canada, Brussels Airlines, Croatia Airlines, Lufthansa, and United Airlines are five of the total of 27 members forming the Star alliance. Both of these alliances constantly adjust their members and services offered to better meet customers’ needs. For example, SriLankan Airlines is scheduled to join Oneworld in 2014 while Qatar Airways is to join the alliance in late 2013 or early 2014. In terms of services, the Star alliance announced in May of 2013 that it was expanding its mobile device capabilities by introducing a customized Navigator application for iPads.

As our discussion shows, complementors expand the set of competitors firms must evaluate when completing a competitor analysis. In this sense, American Airlines and United Airlines examine each other both as direct competitors on multiple routes but also as complementors who are part of different alliances (Oneworld for American and Star for United). In all cases though, ethical commitments and actions should be the foundation on which competitor analyses are developed.

## 2-8 Ethical Considerations

Firms must follow relevant laws and regulations as well as carefully articulated ethical guidelines when gathering competitor intelligence. Industry associations often develop lists of these practices that firms can adopt. Practices considered both legal and ethical include (1) obtaining publicly available information (e.g., court records, competitors’ help-wanted advertisements, annual reports, financial reports of publicly held corporations, and Uniform Commercial Code filings) and (2) attending trade fairs and shows to obtain competitors’ brochures, view their exhibits, and listen to discussions about their products. In contrast,

**Complementors** are companies or networks of companies that sell complementary goods or services that are compatible with the focal firm’s good or service.

certain practices (including blackmail, trespassing, eavesdropping, and stealing drawings, samples, or documents) are widely viewed as unethical and often are illegal as well.

Some competitor intelligence practices may be legal, but a firm must decide whether they are also ethical, given the image it desires as a corporate citizen. Especially with electronic transmissions, the line between legal and ethical practices can be difficult to determine. For example, a firm may develop Web site addresses that are similar to those of its competitors and thus occasionally receive e-mail transmissions that were intended for those competitors. The practice is an example of the challenges companies face in deciding how to gather intelligence about competitors while simultaneously determining how to prevent competitors from learning too much about them. To deal with these challenges, firms should establish principles and take actions that are consistent with them.

Professional associations are available to firms as sources of information regarding competitive intelligence practices. For example, while pursuing its mission to help firms make “better decisions through competitive intelligence,” the association known as the Strategy and Competitive Intelligence Professionals offers codes of professional practice and ethics to firms for their possible use when deciding how to gather competitive intelligence.<sup>123</sup>

Open discussions of intelligence-gathering techniques can help a firm ensure that employees, customers, suppliers, and even potential competitors understand its convictions to follow ethical practices when gathering intelligence about its competitors. An appropriate guideline for competitor intelligence practices is to respect the principles of common morality and the right of competitors not to reveal certain information about their products, operations, and intentions.<sup>124</sup>

## SUMMARY

- The firm's external environment is challenging and complex. Because of its effect on performance, the firm must develop the skills required to identify opportunities and threats that are a part of its external environment.
- The external environment has three major parts: (1) the general environment (segments and elements in the broader society that affect industries and the firms competing in them), (2) the industry environment (factors that influence a firm, its competitive actions and responses, and the industry's profitability potential), and (3) the competitor environment (in which the firm analyzes each major competitor's future objectives, current strategies, assumptions, and capabilities).
- Scanning, monitoring, forecasting, and assessing are the four parts of the external environmental analysis process. Effectively using this process helps the firm in its efforts to identify opportunities and threats.
- The general environment has seven segments: demographic, economic, political/legal, sociocultural, technological, global, and physical. For each segment, the firm has to determine the strategic relevance of environmental changes and trends.
- Compared with the general environment, the industry environment has a more direct effect on the firm's competitive actions and responses. The five forces model of competition includes the threat of entry, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors. By studying these forces, the firm finds a position in an industry where it can influence the forces in its favor or where it can buffer itself from the power of the forces to achieve strategic competitiveness and earn above-average returns.
- Industries are populated with different strategic groups. A strategic group is a collection of firms following similar strategies along similar dimensions. Competitive rivalry is greater within a strategic group than between strategic groups.
- Competitor analysis informs the firm about the future objectives, current strategies, assumptions, and capabilities of the companies with which it competes directly. A thorough competitor analysis examines complementors that support forming and implementing rivals' strategies.
- Different techniques are used to create competitor intelligence: the set of data, information, and knowledge that allows the firm to better understand its competitors and thereby predict their likely competitive actions and responses. Firms absolutely should use only legal and ethical practices to gather intelligence. The Internet enhances firms' ability to gather insights about competitors and their strategic intentions.

REVIEW QUESTIONS

1. Why is it important for a firm to study and understand the external environment?

2. What are the differences between the general environment and the industry environment? Why are these differences important?

3. What is the external environmental analysis process (four parts)? What does the firm want to learn when using this process?

4. What are the seven segments of the general environment? Explain the differences among them.
5. How do the five forces of competition in an industry affect its profitability potential? Explain.

6. What is a strategic group? Of what value is knowledge of the firm's strategic group in formulating that firm's strategy?

7. What is the importance of collecting and interpreting data and information about competitors? What practices should a firm use to gather competitor intelligence and why?

EXPERIENTIAL EXERCISES

EXERCISE 1: CREATING A FIVE FORCES INDUSTRY MODEL

The five forces model is designed to better understand the competitive forces in an industry in which a firm competes. For example, if the combination of forces in an industry serves to restrict or reduce profitability, the industry is said to be unattractive. Naturally the inverse is true—if the combined forces serve to improve or increase the firm's chances for profitability, this is said to be an attractive industry in which to compete.

Michael Porter's analysis explores the three horizontal forces (threat of new entrants, threat of substitutes, and threat from rivals) and two vertical forces (bargaining power of buyers and bargaining power of suppliers).

The following exercise asks you to work in teams to evaluate the U.S. automotive industry. Bear in mind you are evaluating an industry and not a particular firm, and your analysis should be positioned to evaluate the industry in which rivals compete in manufacturing and selling cars and trucks. This exercise will be all the more

compelling since the industry has undergone some relatively significant economic shifts in the past few years as well as the potential for disruption due to new technology.

Each team will be required to present a summary of its analysis using the following table. As you will note after completing the exercise, a five forces model requires some solid research but also requires judgment and intuition as to how the forces interact. There are relatively few concrete answers to any of the forces. Your team should fill out and hand in the accompanying table along with your supporting analysis.

Once your team has identified and supported its rating for each force, summarize the results and indicate your assessment that the industry is either attractive or unattractive with respect to its profitability potential. Also, be prepared to examine the impact of your analysis on an individual firm in the industry.

EXERCISE 2: WHAT DOES THE FUTURE LOOK LIKE?

A critical ingredient to studying the general environment is identifying opportunities and threats. An opportunity is a condition in the environment that, if exploited, helps a company achieve strategic competitiveness. In order to identify opportunities, you must be aware of trends that affect the world around us now or that are projected to do so in the future.

Thomas Fry, executive director and senior futurist at the DaVinci Institute, believes that the chaotic nature of interconnecting trends and the vast array of possibilities that arise from them are somewhat akin to watching a spinning compass needle. From the way we use phones or e-mail, or how we recruit new workers to organizations, the climate for business is changing and shifting dramatically, and at rapidly increasing rates. Sorting these trends out and making sense of them provides the basis for opportunity decision making. Which ones will dominate and which ones will fade? Understanding this is crucial for business success.

Your challenge (either individually or as a group) is to identify a trend, technology, entertainment mode, or design that is likely to

| Overall Rating                | Favorable | Team Rating | Unfavorable |
|-------------------------------|-----------|-------------|-------------|
| Threat of New Entrants        | 10        |             | 1           |
| Intensity of Rivalry          | 10        |             | 1           |
| Threat of Substitutes         | 10        |             | 1           |
| Bargaining Power of Buyers    | 10        |             | 1           |
| Bargaining Power of Suppliers | 10        |             | 1           |

future. Once you  
environment  
come from this.  
and to benefit.

You should consult a wide variety of sources. For example, the Gartner Group and McKinsey & Company both produce market research and forecasts for business. There are also many Web forecasting tools and addresses such as TED (technology, entertainment, design, where you can find videos of their discussions; see [www.ted.com](http://www.ted.com)), that host an annual conference for path-breaking new ideas. Similarly, the DaVinci Institute and the Institute for Global Futures as well as many others have their own unique vision for tomorrow's environment.

**THE NEED TO EXAMINE THE EXTERNAL ENVIRONMENT: DISASTER IN THE GULF THREE-PLUS YEARS LATER**

The Gulf Coast oil spill disaster not only resulted in oil and tar balls washing up on local beaches but contributed to the evaporation of the wedding business on the beach. In one family business, 85 percent of the business and \$90,000 were lost while the firm received only \$20,000 in emergency payments. The first year after the spill, resentful wedding business owners were still living day to day. They contended that British Petroleum (BP), which owned the Deepwater Horizon oil rig where the explosion and subsequent leak occurred, had not fulfilled its obligations to them and their true losses would never be recovered. With government intervention, the \$20 billion fund established by BP had paid out only \$3.8 billion at the end of the first year. Government attorney Kenneth Feinberg emphasized at that time that 200,000 claimants had been compensated in nine months.

Be prepared to discuss the following concepts and questions in class:

**Concepts**

- The external environment
- External environmental analysis

- Five forces of competition
- Strategic groups
- Competitor analysis

**Questions**

1. What parts of the external environment (general, industry, and competitive) do you believe BP considered or didn't consider prior to drilling off the Gulf Coast? What should the wedding business owners now consider in their external environment?
2. How should BP have handled an external environmental analysis and what environmental changes and trends (opportunities and threats) might the firm have discovered?
3. Analyze BP using the five forces of competition model to determine the industry's current attractiveness in terms of profitability potential.
4. Who might be in BP's strategic group and why?
5. What would a competitor of BP now discover about the firm by completing a competitor analysis?

**NOTES**

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