CHAPTER 2

THE EXTERNAL ENVIRONMENT

CHAPTER TOPICS:

This chapter discusses the broad and task environments of business. The broad environment includes the sociocultural, economic, technological, and political/legal forces in the global business environment. Generally, organizations have little influence on the forces in the broad environment and must determine ways to respond. The task environment includes stakeholders such as customers, suppliers, competitors, communities, and financial intermediaries. These groups can often be influenced through stakeholder management tactics such as partnerships, political alliances and participation in social networks.

LEARNING OBJECTIVES:

Upon completion of this chapter on the external environment, students should understand:

- The most important elements of the broad environment, and how they influence business organizations and their task environments.
- The five primary forces that determine the nature and level of competition in an industry.
- How stakeholders in the task environment influence the firm, its performance, and its strategies.
- Cooperative strategies such as political alliances, joint ventures, equity and nonequity strategic alliances, franchising, and participation in alliance networks.
- Global business environments and evaluating a foreign country for investment.

LECTURE OUTLINE:

I. Opening Vignette—Google in China (excerpted here)

China, with its huge population, growing economy, and increasing use of information technology, represents a huge opportunity for Google. Google China was founded in 2005 and originally headed up by Kai-Fu Lee, a former Microsoft executive and celebrated Chinese computer scientist. Google.cn came online in 2006. In spite of very high expectations, the company has experienced continuous difficulties in China and Lee left Google in 2009. Google faces two major challenges in China. The first is Google's top competitor, Baidu, whose website and methods are often compared to Google. The second challenge, censorship, is even more daunting. The Chinese government erected "The Great Firewall of China," a massive and sophisticated national censorship system that uses key-word filtering, Internet address and domain name system tampering, IP address blocking, and other methods to control and restrict the stream of communications entering or exiting China. Although censorship is incongruent with Google's objectives of openness and honesty, the company decided to conform to the government's rules, at least in part. In 2010, in response to a Chinese-originated hacking attack against itself and other companies, Google took a stand and announced that the company would no longer tolerate censorship. Google began redirecting all search queries from Google.cn to Google.com.hk, a website based in Hong Kong, which is protected by international treaties from Chinese laws regarding restrictions on the free flow of information over the Internet. Eventually Google quit redirecting queries automatically and instead provided a link to its Hong Kong–based site.

A. Economic growth and large population bases in places like Brazil, Russia, India, and China are luring multinationals like Google to make massive investments there. However, as this example illustrates, these investments come with difficulties associated with the unique environmental characteristics of each country or region. This chapter is about the influence of the external environment on organizations and how companies can adapt to or influence the environment to enhance their competitive positions.

II. The Broad Environment

A. The most important elements in the broad environment, as it relates to a business organization and its task environment, are global sociocultural, economic, technological, and political/legal forces.

B. Analysis of sociocultural trends is important from at least four perspectives.

1. Most stakeholder groups are also members of society, and some of their values and beliefs are derived from broader societal influences, which can create opportunities and threats for organizations.

2. Firms may enhance their general reputations and reduce the risk of hurting their reputations by anticipating and adjusting for sociocultural trends.

3. Societal trends often represent business opportunities.

4. Correct assessment of sociocultural trends can help businesses avoid restrictive legislation.

Discussion Prompt: *What effect is the aging of the baby boom generation having on each of the following industries: health care, tourism, and food? What are some likely negative consequences of the aging of this population?*

C. Economic forces include economic growth, inflation rates, interest rates, foreign exchange rates, and foreign trade balances.

1. These forces determine the inherent attractiveness of industries—demand, costs, and profitability.

2. Economic and sociocultural forces can interact to create powerful threats and opportunities (e.g., buying power of baby boomers, availability of low-cost immigrant labor).

3. To assess the effect of the interdependent sociocultural and economic forces, organizations often model their business environments using different scenarios. The scenarios are composed of optimistic, pessimistic, and most likely assumptions and interpretations of various economic and sociocultural trend data collected for the process.

Discussion Prompt: *Do all industries benefit from a healthy economy? Which industries are most likely to suffer from a decline in economic prosperity? Which industries are relatively immune to economic trends?*

D. Technological forces create new products, services, and, in some cases, entire new industries. They can change the way society behaves and what society expects. The Internet, hand-held computers, direct satellite systems, and cell phones are technological innovations that have experienced extraordinary growth in recent years, leaving formerly well-established industries stunned, creating whole new industries, and influencing the way many people approach work and leisure.

1. Technology refers to human knowledge about products and services and the way they are made and delivered.

    a. When a new idea or technology is proven to work in the laboratory, it is called an invention.
    b. When an invention can be replicated reliably on a meaningful scale, it is referred to as an innovation.
    c. A basic innovation, such as the microprocessor, lightbulb, fiber optics, or mapping of the human genome, impacts much more than one product category or one industry.

2. To help identify trends and anticipate their timing, organizations may participate in several kinds of technological forecasting efforts, such as trend monitoring, gathering the opinions of experts, scenario development, and collaborative research initiatives with leading technological institutions.

Discussion Prompt: *In addition to the music and video industries, what are some other industries that are being transformed by the Internet? Are the existing companies taking advantage of these technological trends, or are the technological changes being introduced by new companies that enter the market?*

E. Political/legal forces, both at home and abroad, are significant determinants of organizational success.

1. Even in the United States, which is considered a “free” market economy, no organization is allowed the privilege of total autonomy from government regulations. Governments can encourage new business formation through tax incentives and subsidies; they can restructure organizations, as in the case of GM.

2. Alliances and treaties among governments provide an additional level of complexity for organizations with significant foreign operations. For instance, the North American Free Trade Agreement (NAFTA), which altered trade policies among North American countries and the European Union, has had a huge impact on Europe.

3. The amount of time and effort organizations should devote to learning about regulations, complying with them, and fostering good relationships with regulatory agencies and their representatives depends, in part, on the industry.

Discussion Prompt: *The courts once decided that Microsoft was a monopoly. How has the interpretation of monopolies and the government’s role in dissipating their power changed over time?*

III. The Task Environment

A. The task environment consists of stakeholders with whom organizations interact on a regular basis. These stakeholders include domestic and international customers, suppliers, competitors, government agencies and administrators, local communities, activist groups, unions, and financial intermediaries.

B. The competitive forces in an industry are primarily associated with three stakeholders: customers, suppliers and competitors. Competitors may be further divided into existing competitors, potential competitors, and substitute providers. These are the five forces that influence the nature and level of competition in an industry.

1. Industries are often difficult to define, but in general they refer to a group of organizations who compete directly with each other to win orders or sales in the marketplace.

2. Customers create demand for products and services and influence industries by bargaining on quality, prices, new features, delivery, and so on. They are a more powerful influence on industry profit when:

    a. There are a small number of customers.
    b. Many similar products exist for what the customer is buying.
    c. Customers make high-volume purchases.

d. Customers can easily get accurate information on the sellers costs and demand.
e. The products customers are buying are undifferentiated (also known as standard or generic).
f. The customers can easily integrate backward and become their own suppliers.
h. Customers can easily switch from one seller to another.

Discussion Prompt: *Using the checklist above, how powerful are the customers of the pharmaceutical industry? the fast food restaurant industry? the laptop computer industry? What are the implications of these differences in power?*

5. Suppliers to industries provide equipment, supplies, component parts, and raw materials, as well as labor and investment funds. Powerful suppliers influence the industry through prices, quality of goods or services provided, or delivery performance. Supplier power is greater under the following circumstances:

   a. Only a few suppliers are available.
   b. Few substitutes exist for the product or service that is supplied and the buying industry must have it to survive.
   c. Suppliers are not dependent on the buying industry for a large percentage of their total sales.
   d. Suppliers can easily get information on the buying industry's sales growth and profits.
   e. Suppliers have differentiated their products, which means that the buying industry is willing to pay more for certain brands.
   f. Suppliers can easily integrate forward and thus compete directly with their former buyers.
   g. Suppliers make it costly to switch suppliers.

Discussion Prompt: *Using the list above, contrast the power of suppliers to the computer industry? the residential construction industry? the convenience store industry?*

6. Existing competitors jockey with one another for the attention of customers, market share, and the favorable comments of investment analysts. In many industries, every new product introduction, marketing promotion, and capacity expansion have implications for the revenues, costs, and profits of other competitors. Competitive rivalry is more likely to have negative consequences under the following circumstances:

   a. Slow industry growth, which means that competitors must steal market share if they intend to grow.
   b. High fixed costs, which means that firms are under pressure to increase sales to cover their costs and earn profits.

c. Lack of product differentiation, which puts a lot of pressure on prices and often leads to price-cutting strategies.
d. A large number of competitors, which means that the total market must be divided in more ways.
e. High exit barriers, which means that firms may lose all or most of their investments in the industry when they withdraw from it. Therefore, they are more likely to remain in the industry even if profits are low.

7. In some industries, groups of competitors are constrained by similar resource positions and follow similar strategies. The groups or clusters of similar competitors are called strategic groups. One way to keep track of the strategic groups and their behavior over time is with a strategic group map. A strategic group map is constructed by plotting industry rivals based on two or more strategic dimensions that are important to strategy in the industry.

Discussion Prompt: *Contrast the intensity of rivalry in the fast food restaurant industry and the computer industry? What are the most common ways that the competitors compete with each other? What characteristics of these industries work to intensify rivalry?*

8. Strategic group maps can help an organization understand the strategies of competitors. They are constructed by plotting industry rivals based on two or more strategic dimensions that are important to strategy in the industry.

9. New entrants increase competition in an industry, which may drive down prices and profits. They may add capacity, introduce new products or processes, and bring a fresh perspective and new ideas—all of which can drive down prices, increase costs, or both. Forces that keep new entrants out, providing a level of protection for existing competitors, are called entry barriers, and include:

a. Economies of scale, which occur when it is more efficient to produce a product in a larger facility at higher volume.
b. High levels of product differentiation, which means that some firms enjoy a loyal customer base, making it harder for a new firm to draw away customers.
c. High switching costs, which apply not only to suppliers, can also serve as an entry barrier protecting established firms in an industry.
d. Limited access to distribution channels, which may prevent new companies from getting their products to market.
e. Government policies and regulations that limit entry into an industry, effectively preventing new competition.
f. Existing firm possession of resources that are difficult to duplicate in the short term, such as patents, favorable locations, proprietary product technology, government subsidies, or access to scarce raw materials.
g. A past history of aggressive retaliation by industry competitors toward new entrants.

10. If organizations provide goods or services that readily substitute for those provided by an industry, those organizations become indirect competitors.

    a. Close substitutes can place a ceiling on the price that an industry can be charged for a good or service.
    b. Close substitutes establish performance comparisons.

11. Taken together, these forces can result in high, medium, or low barriers. In industries with high entry barriers, few new firms enter the industry, which reduces the competitive intensity and stabilizes profits for industry incumbents. When entry barriers are low, new firms can freely enter the industry, which increases rivalry and depletes profits.

Discussion Prompt: *Contrast the barriers to entry into the fast food restaurant industry and the computer industry. Are barriers to entry getting higher or lower in each of those industries? Why? In addition to book retailing, in what other industries has the Internet allowed new entrants to get around traditional barriers to entry?*

12. An analysis of the five forces is useful from several perspectives.

    a. A firm can better understand how to position itself relative to these forces, determine any sources of competitive advantage now and in the future, and estimate the profits that it can expect.
    b. Managers may alter the influence of the five forces by actions such as erecting higher entry barriers through large-scale economies or greater product differentiation, or by creating switching costs to encourage customer loyalty.
    c. Managers may consider the effects of the five forces before entering an industry or as a basis for deciding to leave an industry.

C. Other important stakeholders, also members of a firm's task environment, include government agencies and administrators, local communities, activist groups, unions, and financial intermediaries.

   1. Like the first three stakeholder groups, each of the other important stakeholder groups may also have economic power, especially to the extent that they possess something the firm needs.

   2. Although economic power is important, it is not the only type of stakeholder power firms should consider when determining their stakeholder management strategies.

3. Political power comes from the ability of a stakeholder to influence the political process in its favor or against the firm. Another type of political power is opinion leadership, the ability to sway public opinion about a firm.

4. Some stakeholders are well positioned relative to other firms and enjoy an additional source of power as a result of network centrality.

5. Stakeholders with high levels of economic power, political power, or network centrality have a large impact on the ability of a firm to achieve its own objectives. In other words, they influence the amount of environmental uncertainty facing the firm.

6. Environmental uncertainty reduces a firm's ability to predict with confidence the future state of its environment, such as demand, competitor actions, new regulation, the cost of supplies, or the availability of labor.

7. Stakeholders that (a) contribute to the environmental uncertainty facing a firm or (b) are able to reduce it should be given higher priority for cooperative strategies.

D. In an effort to deal with global interconnectedness, rapid technological innovation, and the increasing competitiveness of the world economy, organizations are coming together to pursue cooperative strategies in increasing numbers.

1. A strategic alliance is any kind of cooperative strategy in which firms combine resources and capabilities to pursue common objectives.

2. A joint venture is a type of strategic alliance in which two or more firms come together to form a legally independent company. This might also be called an equity strategic alliance.

3. Nonequity strategic alliances are established through contracts among two or more firms. Because firms are not forming an independent organization, there is no equity involved.

4. Both equity and nonequity strategic alliances can be formed to pursue objectives such as developing new products, entering new markets, reducing manufacturing or distribution costs, joint promotion of products and services, dealing with forces in the external environment, or reducing competition by forming exclusive arrangements that make it harder for other firms to compete.

5. Cooperative strategies do not need to involve equity or contractual partnerships with stakeholders. There are many other ways to turn powerful stakeholders into powerful allies.

a. One common technique is to appoint a representative from an important stakeholder firm to the board of directors.
b. Another strategy is to invite stakeholders to participate in research and development projects or to provide input into important organizational decisions.
c. Cooperative strategies that involve multiple stakeholders include trade groups, associations, and research consortia.
d. A franchise is a contractual agreement in which a firm sells another firm's products or services or does business under its trademark in a particular location for a specific period of time

E. Cooperative strategies often provide significant benefits.

1. Many firms are gaining competitive advantages by involving strategically important customers and suppliers in product and process design, in quality training sessions, and in online production scheduling.

2. Competitors are partnering to combat collapsing product and process life cycles and to get a jump on new emerging technologies. Although cooperation in price-setting, called collusion, is illegal in the United States and many other countries, rival organizations may still form partnerships for technological advancement, for new product development, to enter new or foreign markets, or to influence government regulation through lobbying or other political tactics

3. Alliance networks are groups of autonomous firms that cooperate with each other because of mutual interests. These networks are often organized around strategic center or "hub firms," prominent firms with significant power, which coordinate information sharing within the network.

Discussion Prompt: *What has been the response of many firms to the uncertainty brought about by increased globalization? How might partnerships help firms adapt to these opportunities and changes?*

IV. Global Business Environments

A. Significant changes in the global environment have opened up opportunities for organizations that are willing to take a risk and wait patiently for returns.

B. Firms that invest in emerging markets may find unstable governments, inadequately trained workers, low levels of supporting technology, shortages of supplies, a weak transportation system, or an unstable currency. Firms also struggle with managing stakeholders that may have values or beliefs that are different from those of stakeholders found in their home countries. Consequently, it is important to carefully evaluate a foreign environment before making investments.

1. Sociocultural environment of the foreign country.

2. Economic environment of the foreign country and how closely it is linked to other economies.

3. The political/legal environment of the foreign country and the anticipated rate of change of this environment (i.e., upheavals, unrest).

4. The state and availability of technology.

5. Factors associated with the particular business, such as the availability of needed supplies.

C. There are four factors that create favorable business conditions within nations:

1. Factor conditions—such as uncommon raw materials, labor with specific skills, excellent schools or universities.

2. Demand conditions—an available market that can be accessed.

3. Related and supporting industries—availability of networks of suppliers and related industries that are important to success.

4. Firm strategy, structure, and rivalry—conditions that determine the attractiveness of industries may be enhanced by those within a particular nation.

Discussion Prompt: *Referring to the discussion of Google in China in the opening vignette, how would an assessment of China be conducted?*