3 THE EXTERNAL ENVIRONMENT
OBJECTIVES

Upon completion this chapter, you should be able to:

- identify opportunities and threats.
- use a range of tools to analyse the business environment.
- access the significance of environmental factors.
- develop linkages and networks to strengthen your organisation in its environment.
- evaluate the key success factors for your organisation.
- benchmark your organisations performance and financial ability.
- define the competitive environment of your industry in terms of markets, boundaries, competitors and technologies.
3.0 INTRODUCTION

Most firms face external environments that are highly turbulent, complex, and global - conditions that make interpreting them increasingly difficult. To cope with what are often ambiguous and incomplete environmental data and to increase their understanding of the general environment, firms engage in a process called external environmental analysis. Those analysing the external environment should understand that completing this analysis is a difficult, yet significant, activity. In performing an analysis of your organisation’s environment, the following tools and techniques will be essential:

- key success factors.
- benchmarking.
- five forces analysis.
- four Links model.
- PESTLE analysis.
- scenario building.
3.1 EXPLORING THE ENVIRONMENT

As Johnson, 2005 illustrate, there are found to be difficulties associated with developing a connection between the strategy and its environment.

Prescriptive v. Emergent debate
Despite uncertainties, the environment can usefully be predicted for many markets. Others argue that the environment maybe turbulent and therefore, predications may be inaccurate and therefore serve no useful purpose.

Uncertainty
Regardless of the corporate strategy, the environment will always possess an element of uncertainty. New strategies have to be undertaken against a backdrop that cannot be guaranteed and this difficulty must be addressed as corporate strategies are developed.

Range of Influences
In theory, every element of an organisation’s environment may
influence corporate strategy. This makes it difficult for individuals and organisations to manage every item. A solution to this is to identify the factors for success in the industry and then to direct the environmental analysis towards these factors.

When analysing the environment, it is also important to draw a distinction between two types of results from the analysis:

- **proactive outcomes**: the environmental analysis will identify positive opportunities or negative threats. Proactive strategies will then be developed to explore and cope with the situation.

- **reactive outcomes**: environmental analyses will highlight important strategic changes over which the organisation has no control but to which, if they occur, it will need to be able to react.
3.2 OPPORTUNITIES AND THREATS

An important objective of studying the general environment is identifying opportunities and threats. An opportunity is a condition in the general environment that if exploited, helps a company achieve strategic competitiveness. The fact that 1 billion of the world’s total population of 6 billion has cheap access to a telephone is a huge opportunity for global telecommunications companies. And General Electric believes that “e-business represents a revolution that may be the greatest opportunity for growth that the Company has ever seen.” (Pearce & Robinson, 2004)

A threat is a condition in the general environment that may hinder a company’s efforts to achieve strategic competitiveness. The once revered firm Polaroid can attest to the seriousness of external threats. Polaroid was a leader in its industry and considered one of the top 50 firms in the United States, but filed for bankruptcy in 2001. When its competitors developed photographic equipment using digital technology, Polaroid was unprepared and never responded effectively. Mired in substantial debt, Polaroid was unable to reduce its costs to acceptable levels and eventually had to declare bankruptcy. (Pearce & Robinson, 2004)
Activity

1) Why is it a necessity in strategic terms for an organisation to analyse its environment?

2) Identify key opportunities and threats firstly for your organisation and then for a large organisation of your choice. Compare and contrast your findings.
3.3 DEFINING YOUR INDUSTRY

The industry context is made up from:

- customers or buyers - who purchase goods or services from your organisation.
- suppliers - who supply services or products to your organisation.
- competitors - those who are competing to win your customers.

Therefore it is in an organisation's best interest not to lose sight of the importance of customers when searching for competitive advantages for your organisation. One way of linking customers to your organisation is by analysing key success factors.
3.4 KEY SUCCESS FACTORS

Key success factors (KSFs) or critical success factors as they are sometimes known are the resources, skills and attributes of the organisations in the industry that are essential to deliver success in the marketplace. As Daft, 2005 reveals, success often means profitability. KSF for organisations are common within industries and do not differentiate between companies. An example is the steel industry where common KSF include:

- general wage levels in the country.
- government regulations and attitudes to worker redundancy, because high wage costs can be reduced by sacking employees.
- trade union strength to fight labour force redundancies.

KSF do however differentiate between industries and that is why it is important to identify them for particular industries. KSFs can be used to assess the ‘health of the business’; the indicators of success or failure. By comparing your organisation’s KSFs with those of your main competitors you can identify possible relative strengths and weaknesses which may indicate areas for improvement. Many organisations have already identified a few key success factors. Some of the main areas for KSFs are as follows:

- business performance, e.g. fast, efficient service, customer perception.
- quality, e.g. reliability of product or service, warranty claims.
- product or service features, e.g. cost-effectiveness, reliability, value for money.
- marketing, e.g. market share, image, brand names, pricing.
- operational effectiveness, e.g. process technology, efficiency, information systems.
- technology and development, e.g. technical leadership, new products and processes.
- people, e.g. levels of achievement and skills.
Activity

This activity asks you to compare your organisation’s KSF’s with its competitors’ on an industry specific basis. You may be able to draw on published information about your organisation and competitors. If not, you will need to think about the essential features for success in your industry. The simplest way is to ask the question, ‘From our customers’ point of view, what are the key things that any competitor has to do right to succeed?

1) Identify your organisation’s key success factors and note them in the first column below.

2) Consider the KSFs of two of your main competitors and add any not yet listed to the first column.

3) What importance does each organisation attach to each key success factor? In column 2, prioritise the KSFs for your organisation by rating them 1, 2, 3 and so on, with 1 meaning that your organisation puts most effort into this area. Then do the same for competitor 1 and competitor 2.
3.5 BENCHMARKING

Over the past decades several definitions of benchmarking have come to existence. Benchmarking can be defined as a sophisticated method of pinpointing areas of improvement in every business process. A more recent definition used by the electronic college of process innovation states that: “benchmarking is the search for industry best practices that lead to superior performances”.

Best practices refer to business practices that outperform all other business practices in any specific industry. In other words, there are no other organisations that perform those practices better. Best practices can be achieved through innovation inside the organisation. However it is likely that most innovations have already been discovered and implemented elsewhere. So in order to achieve best practices in your call center, you might want to look beyond the walls of your own organisation to see what others are doing. Benchmarking is the methodology to assist you in doing so. One should keep in mind though that benchmarking with partners who are less than best-in-class may lead to improved performance but will never make you reach the highest level of performance increase possible. Of all the benchmarking methodologies, the two most widely used are competitive benchmarking and process benchmarking. If you are trying to position your performance rank within your industry, competitive benchmarking is the best bet. With competitive benchmarking you measure the performance of your call center directly against that of your competitors. Process benchmarking, by contrast, measures business processes or practices that are important to the performance of your call center, and does this across industries. This type of benchmarking identifies best practices used, regardless of your position in the industry, and proceeds with a thorough study of the processes, and the implementation of these practices in your call center. (Recklies, 2006)

**Advantages Of Benchmarking**

Benchmarking is not just copying or catch-up neither is it spying
or industrial espionage, and it definitively is not quick and easy to accomplish. So why would you, or should you, benchmark your?

First of all, benchmarking can be effective at all levels of operations. The idea behind benchmarking is simple: the most effective way to implement changes is by learning from positive experiences that others have had in the past. As Recklies, 2006 illustrates, benchmarking helps you to:

- expose areas where improvement is needed,
- pinpoints areas for cost reduction,
- it assesses performance objectively, and
- you can use it to test whether your improvement initiatives have been successful.

Furthermore benchmarking encourages striving for perfection and innovative thinking, it can help you to create a better understanding of your industry and it is the most effective tool to identify best-in-class business practices, with a view to their adoption. If you want to calculate the gap between how your organisation is performing and how your organisation wants to perform, benchmarking is the measurement tool to help you find out.

Since, a better understanding of your industry will lead to innovative thinking, and you will be able to achieve your desired level of performance more rapidly. Benchmarking does not limit itself by only looking at competitive information. It eliminates the guesswork by studying the existing processes and enablers that will lead to best practices, and it encourages innovation by looking outside your industry’s zone of comfort.

Although benchmarking is a useful tool for achieving operational effectiveness, it is important to realise that operational effectiveness alone does not lead to sustained competitive advantage. It is too easily imitated. As leading analyst Michael Porter suggested, ‘The more benchmarking companies do, the more they look alike.’ Although companies can continue to seek to adopt new technologies and new systems and processes to gain profitability, in the long run, it does not lead to them achieving a relative advantage over their competitors, because competitors can quickly adopt these operation improvements for themselves (Porter, 1996).
Activity

Look for your organisation's published financial results for the previous year and compare its results to its nearest competitors. Based on the illustrated results, reveal the areas where your organisation needs to improve and where it has a relative advantage.
3.6 FIVE FORCES ANALYSIS

An industry analysis involves looking at the forces influencing the organisation. The objective of such a study is to develop the competitive advantage of the organisation and enable it to defeat its rival companies. *Porter’s 5 Forces* identifies five basic forces that can act on the organisation:

1) the bargaining power of *suppliers*.
2) the bargaining power of *buyers*.
3) the threat of potential *new entrants*.
4) the threat of *substitutes*.
5) the extent of *industry competitors*.

The objective of this analysis is to investigate how the organisation needs to form its strategy in order to develop opportunities in its environment and protect itself against competition and other threats. It revolves around the forces driving industry competition. These general principles can also be applied to Non Profitable Organisations where they compete for resources such as government funding and charitable donations.

Porter identifies five forces that shape the level of competition and underlying profit opportunities within an industry. These forces are shown in the diagram below. By analysing these five forces managers can identify the factors in their industry which make it more or less difficult to achieve a competitive advantage. They are then in a much better position to develop successful strategies. We will look at these forces in turn.
**Bargaining Power Of Suppliers**

The term ‘suppliers’ comprises all sources for inputs that are needed in order to provide goods or services. Supplier bargaining power is likely to be high when:

- the market is dominated by a few large suppliers rather than a fragmented source of supply.
- there are no substitutes for the particular input.
- the suppliers customers are fragmented, so their bargaining power is low.
- the switching costs from one supplier to another are high.
- there is the possibility of the supplier integrating forwards in order to obtain higher prices and margins.

This threat is especially high when:

- the buying industry has a higher profitability than the supplying industry.
- forward integration provides economies of scale for the supplier.
- the buying industry hinders the supplying industry
in their development (e.g. reluctance to accept new releases of products).
* the buying industry has low barriers to entry.

In such situations, the buying industry often faces a high pressure on margins from their suppliers. The relationship to powerful suppliers can potentially reduce strategic options for the organisation.

**Bargaining Power Of Customers**

Similarly, the bargaining power of customers determines how much customers can impose pressure on margins and volumes. Customers bargaining power is likely to be high when:

- they buy large volumes, there is a concentration of buyers.
- the supplying industry comprises a large number of small operators.
- the supplying industry operates with high fixed costs.
- the product is undifferentiated and can be replaced by substitutes.
- switching to an alternative product is relatively simple and is not related to high costs.
- customers have low margins and are price-sensitive.
- customers could produce the product themselves.
- the product is not of strategical importance for the customer.
- the customer knows about the production costs of the product.
- there is the possibility for the customer integrating backwards.

**Threat Of New Entrants**

The competition in an industry will be the higher, the easier it is for other companies to enter this industry. In such a situation,
new entrants could change major determinants of the market environment (e.g. market shares, prices, customer loyalty) at any time. There is always a latent pressure for reaction and adjustment for existing players in this industry. The threat of new entries will depend on the extent to which there are barriers to entry. These are typically:

- economies of scale (minimum size requirements for profitable operations).
- high initial investments and fixed costs.
- cost advantages of existing players due to experience curve effects of operation with fully depreciated assets.
- brand loyalty of customers.
- protected intellectual property like patents, licenses etc.
- scarcity of important resources, e.g. qualified expert staff.
- access to raw materials is controlled by existing players.
- distribution channels are controlled by existing players.
- existing players have close customer relations, e.g. from long-term service contracts.
- high switching costs for customers.
- legislation and government action.

**Threat Of Substitutes**

A threat from substitutes exists if there are alternative products with lower prices of better performance parameters for the same purpose. They could potentially attract a significant proportion of market volume and hence reduce the potential sales volume for existing players. This category also relates to complementary products. Similarly to the threat of new entrants, the treat of substitutes is determined by factors like:

- brand loyalty of customers.
- close customer relationships.
- switching costs for customers.
- the relative price for performance of substitutes.
- current trends.
**Competitive Rivalry Between Existing Players**

This force describes the intensity of competition between existing players (companies) in an industry. High competitive pressure results in pressure on prices, margins, and hence, on profitability for every single company in the industry. Competition between existing players is likely to be high when:

- there are many players of about the same size.
- players have similar strategies.
- there is not much differentiation between players and their products, hence, there is much price competition.
- low market growth rates (growth of a particular company is possible only at the expense of a competitor).
- barriers for exit are high (e.g. expensive and highly specialised equipment).

**Use Of The Information Form Five Forces Analysis**

Five forces analysis can provide valuable information for three aspects of corporate planning. (Recklies, 2006)

1) *Statical Analysis*

The Five Forces Analysis allows determining the attractiveness of an industry. It provides insights on profitability. Thus, it supports decisions about entry to or exit from and industry or a market segment. Moreover, the model can be used to compare the impact of competitive forces on the own organisation with their impact on competitors. Competitors may have different options to react to changes in competitive forces from their different resources and competences. This may influence the structure of the whole industry.

2) *Dynamical Analysis*

In combination with a PESTLE-Analysis, which reveals drivers for change in an industry, Five Forces Analysis can reveal insights about the potential future attractiveness of the industry. Expected
political, economical, socio-demographical and technological changes can influence the five competitive forces and thus have impact on industry structures. Useful tools to determine potential changes of competitive forces are scenarios.

3) Analysis of Options

With the knowledge about intensity and power of competitive forces, organisations can develop options to influence them in a way that improves their own competitive position. The result could be a new strategic direction, e.g. a new positioning, differentiation for competitive products of strategic partnerships.

Thus, Porters model of Five Competitive Forces allows a systematic and structured analysis of market structure and competitive situation. The model can be applied to particular companies, market segments, industries or regions. Therefore, it is necessary to determine the scope of the market to be analysed in a first step. Following, all relevant forces for this market are identified and analysed. Hence, it is not necessary to analyse all elements of all competitive forces with the same depth. The Five Forces Model is based on microeconomics. It takes into account supply and demand, complementary products and substitutes, the relationship between volume of production and cost of production, and market structures like monopoly, oligopoly or perfect competition. (Hitt & Ireland, 2003)

Influencing The Power Of Five Forces

After the analysis of current and potential future state of the five competitive forces, managers can search for options to influence these forces in their organisation’s interest. Although industry-specific business models will limit options, the own strategy can change the impact of competitive forces on the organisation. The objective is to reduce the power of competitive forces.

The following list provides some examples. They are of general nature. Hence, they have to be adjusted to each organisation’s specific situation. The options of an organisation are determined not only by the external market environment, but also by its own internal resources, competences and objectives.
1) **Reducing the Bargaining Power of Suppliers**
   - Partnering.
   - Supply chain management.
   - Supply chain training.
   - Increase dependency.
   - Build knowledge of supplier costs and methods.
   - Take over a supplier.

2) **Reducing the Bargaining Power of Customers**
   - Partnering.
   - Supply chain management.
   - Increase loyalty.
   - Increase incentives and value added.
   - Move purchase decision away from price.
   - Cut put powerful intermediaries.

3) **Reducing the Treat of New Entrants**
   - Increase minimum efficient scales of operations.
   - Create a marketing / brand image (loyalty as a barrier).
   - Intellectual property.
   - Alliances with linked products / services.
   - Tie up with suppliers.
   - Tie up with distributors.
   - Retaliation tactics.

4) **Reducing the Threat of Substitutes**
   - Legal actions.
   - Increase switching costs.
   - Alliances.
   - Customer surveys to learn about their preferences.
   - Enter substitute market and influence from within.
   - Accentuate differences (real or perceived).
5) Reducing the Competitive Rivalry between Existing Players

- Avoid price competition.
- Differentiate your product.
- Buy out competition.
- Reduce industry over-capacity.
- Focus on different segments.
- Communicate with competitors.

Criticisms Of Porter’s Five Forces Model

Porter’s model of Five Competitive Forces has been subject of much critique. Its main weakness results from the historical context in which it was developed. In the early eighties, cyclical growth characterised the global economy. Thus, primary corporate objectives consisted of profitability and survival. A major prerequisite for achieving these objectives has been optimisation of strategy in relation to the external environment. At that time, development in most industries has been fairly stable and predictable, compared with today’s dynamics. In general, the meaningfulness of this model is reduced by the following factors: (Daft, 2005)

- in the economic sense, the model assumes a classic perfect market. The more an industry is regulated, the less meaningful insights the model can deliver.
- the model is best applicable for analysis of simple market structures. A comprehensive description and analysis of all five forces gets very difficult in complex industries with multiple interrelations, product groups, by-products and segments. A too narrow focus on particular segments of such industries, however, bears the risk of missing important elements.
- the model assumes relatively static market structures. This is hardly the case in today’s dynamic markets. Technological breakthroughs and dynamic market entrants from start-ups or other industries may completely change business models, entry barriers and relationships along the supply chain within short times. The Five Forces model may have some use for later
analysis of the new situation; but it will hardly provide much meaningful advice for preventive actions.

- the model is based on the idea of competition. It assumes that companies try to achieve competitive advantages over other players in the markets as well as over suppliers or customers. With this focus, it does not really take into consideration strategies like strategic alliances, electronic linking of information systems of all companies along a value chain, virtual enterprise-networks or others.

Overall, Porters Five Forces Model has some major limitations in today’s market environment. It is not able to take into account new business models and the dynamics of markets. The value of Porters model is more that it enables managers to think about the current situation of their industry in a structured, easy-to-understand way - as a starting point for further analysis.
Activity

Choose an industry in which you would like to compete. Use the five-forces method of analysis to explain why you find that industry attractive on a profit potential basis.
3.7 THE FOUR LINKS MODEL

As well as competing with rivals, most organisations also form alliances with others through formal or informal relationships. Unlike Porter’s, the Four Links Model stresses the importance of forming links with rivals to achieve the following:

- sustainable competitive advantages.
- produce lower costs.
- deliver more sustainable relationships with parties outside the organisation.

It must be noted that collusion between organisations to rig markets is an illegal activity in most countries. (Daft, 2005)

Informal Links And Networks

These are links created for a mutual or common purpose that are not legally binding and may occur by accident or by design. They include many forms of contracts such as formal industrial bodies representing matters with other interested parties e.g. Confederation of Iron and Steel Industries; and informal contracts that take place between like-minded individuals from a variety of industries at a social function e.g. a local Chamber of Commerce meeting. Often, organisations outside these networks lose out on competitive advantages.
**Formal Co-operative Linkages**

These are bound together by some form of legal contract and usually include joint ventures and partnerships involving a higher degree of formality to ensure permanence of linkages. Strengths and weaknesses should be measured in terms of their depth, longevity and degree of mutual trust.

**Government Links And Networks**

These usually involve relationships with a country’s national parliament, regional assemblies and the associated government administrations. In some cases, these linkages may extend beyond national boundaries e.g. EU and other international treaties. They may also be formal or informal. Such links may be vital in tax and legal matters e.g. interpretation of competition law.

**Complementors**

Those companies whose products add more value to the products of the base organisation are known as complementors. E.g. Play station games for the Sony Play station.
Activity

Analyse the co-operative environment of your organisation using the four-links model and reveal the form of linkages currently pursued by your organisation. Having done that, go on to give recommendations on other linkages that you feel your organisation should or could pursue in order to be more successful.
3.8 PESTLE ANALYSIS

You can use PESTLE analysis to identify forces in the macro-environment that are affecting your business now and are likely to continue to do so in the future. You examine Political, Economic, Socio-cultural, Technological, Legislative and Ecological aspects of the wider environment. There are different opinions in literature about the inclusion of legal and ecological factors. Their importance doubtlessly differs from industry to industry. In case such factors are of high relevance to an industry, they should be analysed separately. In industries that are less influenced by legal and ecological factors, they could be allocated to the other categories, e.g. legislation as a political factor or ecological awareness as a socio-cultural factor. In any case it is important to include only external factors which an organisation cannot influence by itself. (Recklies, 2006)

Checklist of issues:

- **political** - government policies, attitudes to industry, competition, monopolies, government stability, taxation policies, foreign trade regulations, political alignments at local, national, regional and global level.

- **economic** - GNP and GDP, inflation, interest rates, exchange rates, investment by state, private enterprise, consumer expenditure, disposable income, infrastructure costs and availability, e.g. energy, transport and communications.

- **socio-cultural** - demography, consumerism, education and health, social attitudes to work, health, the environment, social mobility, income distribution.

- **technological** - government spending on research, adoption of new technology, new products and developments, obsolescence of existing technology.

- **legislation** - employment law, taxation law, company law, health and safety law, patent law, industry regulations.

- **ecological** - pollution control, planning policies, transport policies, disposal of waste.
Application

Regarding the subject of analysis, the PESTLE tool can be used to analyse business segments, industries, particular markets or whole economies. Thus the PESTLE provides a summary of the driving forces in the macro environment. It identifies drivers that were of high importance in the past, indicates to what extent they might change in future and how this will interfere with the organisation or the whole industry. Depending on the objective of the analysis, a distinction between the current situation and potential future changes may be helpful.

In order to gain really meaningful results it is not enough to understand the PESTLE as a mere list of drivers. It rather is a starting point for further analysis of the external environment.

For instance it is possible to identify different external drivers for change with the help of the PESTLE. These are such drivers that will influence and change the industry structures or market structures in all likelihood. For example, the combination of the factors deregulation of trade barriers, improvement of communication technology, increasing competitive pressure on local markets and converging customer preferences are likely to be drivers for further globalisation.

Starting from the PESTLE it is possible to analyse the different levels of impact that particular drivers will have on an organisation. The examination of historical developments is equally important as the analysis of future trends in this context. An impact-uncertainty-matrix is a helpful means for visualisation.
Recklies, 2006

It may also be helpful to assess the impact of the most important drivers on the organisations’ competitors. Provided there is sufficient information available about the competitors’ competences, strengths and weaknesses, it is possible to derive ideas about:

- the extent to which a competitor may be able to exploit new chances or to handle risks arising in the environment.
- how the competitor might react to these changes.

The application of the PESTLE has proven useful in practice in two ways.

1) **For compiling and structuring of information.**

    Normally, huge amounts of information are compiled in early stages of the analysis of new markets or business segments. Pre-sorting this information into the four PEST-categories can help to get the general idea and will serve as a starting point for further structuring of the relevant pieces of information. Used in this way, the PEST will naturally comprise comprehensive and detailed lists.
2) **As a means of presentation.** The PEST-scheme is a helpful structure for presentations, e.g. of the results of market analyses. Here it can serve as an executive summary. The first slide would cover the most important findings under the four PEST-headlines. At this stage, no category should comprise more than two to four distinct findings. The following slides would discuss these findings in more detail; political, economical etc. issues on one or two slides each. The PEST offers an easily comprehensible presentation structure since it is widely known and easy to understand.
Activity

Briefly describe two important changes in the remote environment of your country businesses in each of the following areas:

1) Economic

2) Social

3) Political

4) Technological

5) Ecological
3.9 A TURBULENT ENVIRONMENT

**Changeability**
The degree to which the environment is likely to change. This comprises of:
- **Complexity**: The degree to which the organisation’s environment is affected by factors such as internationalisation and technological, social and political complications.
- **Novelty**: The degree to which the environment presents the organisation with new situations.

**Predictability**
The degree to which such changes can be predicted. This comprises of:
- **Rate of Change**.
- **Visibility of the Future** in terms of the availability and usefulness of the information used to predict the future.

From these measures, we can create a spectrum that categorises the environment and provides a rating for its degree of turbulence. Courtney, Kirkland and Viguerie (2005) argue that there is often much that can be known about the future and describe four different levels of uncertainty:

1) level 1 is a clear-enough future where current trends can be extrapolated into the future.
2) level 2 is where there are several discrete alternative outcomes.
3) level 3 is a range of possible outcomes, with no clarity about how the different influences will interact to create the future.
4) level 4 is true ambiguity - anything could happen.
Activity

Determine the level of turbulence for your organisation in its environment.
3.10 SCENARIO ANALYSIS

In conditions of uncertainty, managers can use scenarios to help them develop their awareness of the environmental opportunities and threats they face so that they can make appropriate decisions. Scenario analysis is a process of analysing possible future events by considering alternative possible outcomes (scenarios). The analysis is designed to allow improved decision-making by allowing more complete consideration of outcomes and their implications. Scenario analysis is a practice that has existed as long as humans have walked this Earth. A mariner contemplates the possibility that his ship may be afflicted by storms or pirates, or scurvy. He thinks about how he would respond to each, and what the consequences might be. He toys with different scenarios and different responses. He considers the likelihood of each scenario. Based on that, and what he perceives would be the outcome of each, he plans his next voyage. This sort of “what if” analysis has always been a part of business decision-making. (Hitt & Ireland, 2002)

Today, what we call scenario analysis is a formalisation of the process. Formalised scenario analysis is used in asset-liability management and corporate risk management. It originated in the 1970s and 1980s among banks and insurance companies when volatility in interest rates emerged as a threat to their balance sheets. Its primary use remains the analysis of interest rate risk, but corporations apply it for a variety of risks. Scenario analysis starts with scenarios. A simple analysis might consider three scenarios, say reflecting assumptions that the economy will experience:

- strong growth,
- moderate growth, or
- a decline.

Scenarios are useful when there is a high level of uncertainty. Building a scenario involves creating plausible pictures or case studies of the future based on environmental forces for change. The aim is to explore a range of possibilities. These can then be examined for their implications on the business and can lead to strategic decisions. Scenarios aid creative thinking. They help
managers expand their viewpoint and challenge their assumptions. You can use scenarios in a number of ways:

- to identify the signals in the environment to monitor for indications of change as suggested in the scenario-building exercise.

- to identify business characteristics that might be strengths and weaknesses in the different circumstances suggested by the scenarios.

- to suggest ways in which the business could prepare for change as indicated by the various scenarios. These may be small projects or initiatives - ‘seed setting’ - to develop competences that could be expanded as the need arises. Such activities can be seen as developing flexibility and keeping options open in the face of uncertainty.

- to give people an insight into the need for change. They can be useful for overcoming resistance to change.

Scenario building is based on intuition - derived from your expertise, knowledge and judgement as a manager. They may be time-consuming to create but they help you develop an understanding of how external environment forces can combine and interrelate to create change for your organisation. They also give you a wider perspective on your business and where it could or should be heading.
Activity

Identify and illustrate five potential ‘what if ’ issues that will affect your organisations position in the coming years. Based on this, perform a scenario analysis to determine how your organisation should overcome them.
3.11 SUMMARY

This section has helped you to examine the context in which your organisation operates and to identify forces that influence change. It is vital to have an understanding of the external environment, thus enabling a quick response to opportunities and threats.

The tools and techniques we have used in this section are summarised below.

*Key success factors (KSFs)*
These are the critical things in an industry that management has to get right if the organisation is to be successful.

*Benchmarking*
The search for industry best practices that lead to superior performances. Best practices refer to business practices that outperform all other business practices in any specific industry.

*Five forces analysis*
By analysing these five forces managers can identify the factors in their industry which make it more or less difficult to achieve a competitive advantage. They are then in a much better position to develop successful strategies. Porter identifies five forces that shape the level of competition and underlying profit opportunities in an industry. They are:

- bargaining strength of buyers.
- bargaining strength of suppliers.
- threat of substitutes.
- threat of new entrants.
- rivalry between existing businesses in the industry.

*PESTLE analysis*
This is a way of examining the political, economic, socio-cultural, technological, legislative and ecological aspects of the macroenvironment that affect your industry and organisation.
**Four Links Model**
As well as competing with rivals, most organisations also form alliances with others through formal or informal relationships. Unlike Porter’s, the Four Links Model stresses the importance of forming links with rivals to achieve competitive advantages.

**Scenario analysis**
In conditions of uncertainty, managers can use scenarios to help them develop their awareness of the environmental opportunities and threats they face so that they can make appropriate decisions. Scenario analysis is a process of analysing possible future events by considering alternative possible outcomes.
Test Questions

1) Evaluate the utility and limitations of Porters five forces.

2) Discuss why firms pursue co-operative agreements, illustrating your answer using the four links model.

3) Why is it important for a firm to study and understand the external environment?

4) How do the five forces of competition in an industry affect its profit potential? Explain.


6) How does turbulence affect an organisation’s competitive environment?

7) Describe five major changes that you expect to have a major impact on the oil industry in the next 10 years. Use PESTLE in your analysis.

8) Why do organisations perform scenario analysis?

9) Why is it important for an organisation to recognise its key success factors?

10) What are the limitations of Porter’s five forces and how can one overcome it?