# Chapter 3: Evaluating the External Environment



*Learning Objectives*

After reading this chapter, you should be able to understand and articulate answers to the following questions:

1. What is the macro environment and why is it important to organizations?
2. How is the PESTEL framework used to evaluate the external environment?
3. How is the Porter's Five Forces tool used to perform a competitive analysis of an industry?
4. What are strategic groups and how are they useful to evaluating the competitive environment?

## 3.1 Introduction

Businesses operate within an external macro-environment that affects the likelihood of their overall success or failure. Forces beyond the control of businesses can hinder the growth of a business or perhaps be harnessed to propel it forward. Strategic management requires that these external and competitive forces be evaluated, so that opportunities may be leveraged and threats may be mitigated as strategies are developed to improve the success of the firm.

This chapter will introduce three tools that help firms assess different perspectives of their competitive environment. The PESTEL framework (Political, Economic, Socio-cultural, Environmental/Ecological, and Legal) evaluates the macro-environment through the evaluation of six external forces. The competitive environment of the industry also must be evaluated through Porter's Five Forces tool. Finally, Strategic Group Mapping helps executives understand how their firm relates to other competitors in the market, and which are their most direct competitors. Once this external analysis is complete, a firm can determine the true strategic issue(s) it faces and can develop strategies to work on strategic issues that move the firm forward toward accomplishing its vision.

## Panera Bread: Riding the Trends


*Figure 3.1: Panera Bread took advantage of some external forces to expand rapidly.*

Founded in 1981 in Boston, Panera Bread was originally a single shop called the Cookie Jar. The following year, its founder, Ron Shaich, merged with Au Bon Pain, a struggling French Bakery in the US. They began to sell soups and fresh sandwiches, at a time when most lunch options were fast food or sit-down restaurants. Shaich sensed two socio-cultural emerging trends in the 1990's. One was the movement toward healthy eating. The other was the public's desire for what would become the "fast casual" restaurant where customers could order at the counter, get their meal quickly, have better food choices than fast food, and dine in an atmosphere conducive to having meetings with friends or business associates. Starbucks helped to stimulate the popularity of the fast casual boom. Shaich sold off Au Bon Pain and focused on building a brand of chain restaurants called Panera Bread.

By 2010 there was a new Panera Bread opening every three days. Staying ahead of the technological forces in the industry, Shaich implemented digital ordering, a loyalty program, and a catering and delivery service. The industry has adopted many of Panera Bread's innovations. By 2017, it had become one of America's most successful restaurant chains and had expanded into Canada. Panera now has over 2000 locations, over 100,000 employees, and its stock is one of the best performers in the industry. Shaick was able to take advantage of emerging trends in the US environment to build a very successful business.

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Figure 3.1: Miosotis Jade. A Drive-Through Location Windermere FL. CC BY-SA 4.0. Retrieved from https://en.wikipedia.org/wiki/Panera_Bread#/media/File:Panera_Bread.jpg.

# 3.2 The Relationship between an Organization and its Environment

## What Is the Environment?

For any organization, the environment consists of the set of external conditions and forces that have the potential to influence the organization. In the case of Panera Bread, for example, the environment contains its customers, its rivals such as Chipotle and Starbucks, social trends such as the shift in society toward healthier eating, political entities such as the US Congress, and many additional conditions and forces.

It is useful to break the concept of the competitive environment for a business down into two components: the general environment and its industry. The general environment, or macro-environment, includes overall trends and events in society such as social trends, technological trends, demographics, and economic conditions. The industry, or competitive environment, consists of multiple organizations that collectively compete with one another by providing similar goods, services, or both.

Every action that an organization takes, such as raising its prices or launching an advertising campaign, creates some degree of change in the world around it. Most organizations are limited to influencing their industry. Subway's move to cut salt in its sandwiches, for example, may lead other fast-food firms to revisit the amount of salt contained in their products. A few organizations wield such power and influence that they can shape some elements of the general environment. For instance, McDonalds's transition to cage free eggs by 2030 may impact the entire US supply chain for eggs because McDonalds alone purchases approximately 4% of all eggs produced annually, but only 10% of the eggs produced in 2018 were cage free. However, most organizations simply react to major technological trends, for example, the actions of firms such as Intel, Microsoft, and Apple help create these trends. Some aspects of the general environment, such as demographics, simply must be taken as a given by all organizations. Overall, the environment has a far greater influence on most organizations than most organizations have on the environment.

## Why Does the Environment Matter?

Understanding the environment that surrounds an organization is important to the executives in charge of the organizations. There are several reasons for this. First, the environment provides resources that an organization needs in order to create goods and services. In the seventeenth century, British poet John Donne famously noted that "no man is an island." Similarly, it is accurate to say that no organization is self-sufficient. As the human body must consume oxygen, food, and water, an organization needs to take in resources such as labor, money, and raw materials from outside its boundaries. Panera Bread, for example, simply would cease to exist without the employees that operate its stores, the suppliers that provide food and other necessary inputs, and the customers who provide Panera Bread with money through purchasing its products. An organization cannot survive without the support of its environment.

*Figure 3.2: Natural disasters devastate many organizations.*

Second, the environment is a source of opportunities and threats for an organization. Opportunities are events and trends that create chances to improve an organization's performance level. In the late 1990s, for example, the trends toward obesity in the US and the need for healthy eating helped Panera Bread position itself as a healthy alternative to traditional fast-food restaurants. Threats are events and trends that may undermine an organization's performance. Panera Bread faces a threat from some upstart restaurant chains. Saladworks, for example, offers a variety of salads that contain fewer than five hundred calories. Noodles and Company offers a variety of sandwiches, pasta dishes, and salads that contain fewer than four hundred calories. These two firms are much smaller than Panera Bread, but they could grow to become substantial threats to Panera's positioning as a healthy eatery. Panera Bread and other firms must deal with the uncertainty and other impacts of COVID with could threaten this industry for a long period.

Executives also must realize that virtually any environmental trend or event is likely to create opportunities for some organizations and threats for others. This is true even in extreme cases. In addition to horrible human death and suffering, the March 2011 earthquake and tsunami in Japan devastated many organizations, ranging from small businesses that were simply wiped out to corporate giants such as Toyota, whose manufacturing capabilities were undermined. As odd as it may seem, however, these tragic events also opened up significant opportunities for other organizations. The rebuilding of infrastructure and dwellings requires concrete, steel, and other materials. Japanese concrete manufacturers, steelmakers, and construction companies benefited in the wake of this tragedy.

Third, the environment shapes the various strategic decisions that executives make as they attempt to lead their organizations to success. The environment often places important constraints on an organization's goals, for example. A firm that sets a goal of increasing annual sales by 50% might struggle to achieve this goal during an economic recession or if several new competitors enter its market. Environmental conditions also need to be taken into account when examining whether to start doing business in a new country, acquire another company, or launch an innovative product, to name just a few.

### *Key Takeaway*

- An organization's environment is a major consideration in strategic assessment. The environment is the source of resources that the organization needs. It provides opportunities and threats, and it influences the various strategic decisions that executives must make.

### *Exercises*

1. What are the three reasons that the environment matters?
2. Which of these three reasons is most important? Why?
3. Can you identify an environmental trend that no organization can influence?

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## Image Credits

Figure 3.2: Kim Seng. Monthly Newsletter-November 2011. CC BY-NC-ND 2.0. Retrieved from https://www.flickr.com/photos/captainkimo/6356997605.

# 3.3 Evaluating the General Environment

## The Elements of the General Environment: PESTEL Analysis

An organization's environment includes factors that it can readily affect as well as factors that largely lay beyond its influence. The latter set of factors are said to exist within the general environment. Executives must track trends and events as they evolve and try to anticipate the implications of these trends and events because the general environment often has a substantial influence on an organization's level of success.

**PESTEL analysis** is one important tool that executives can rely on to organize factors within the general environment and to identify how these factors influence industries and the firms within them. PESTEL is an acronym, meaning it is an abbreviation formed from the initial letters of other words. PESTEL reflects the names of the six segments of the general environment: (1) political, (2) economic, (3) socio-cultural, (4) technological, (5) environmental, and (6) legal. Wise executives carefully examine each of these six segments to identify major opportunities and threats and then adjust their firms' strategies accordingly (Table 3.1).

Before applying the PESTEL framework, it is important to identify which industry is being evaluated. For example, for using this tool for Panera Bread, what industry is Panera Bread in? If the food service industry is selected, then this includes all types of restaurants, from McDonalds to expensive, five-star restaurants. The food service industry also includes hospital and university cafeterias and catering services. To provide a more accurate assessment for Panera Bread, a smaller segment of the food service industry should be chosen. How about the restaurant industry? This is still too broad. Picking a segment of the restaurant industry, the fast casual restaurant industry, is the most helpful to analyze using PESTEL. To help determine what industry to select, ask "Who does the company directly compete against, head to head?" In this case, Panera Bread competes head to head with other fast casual restaurants. McDonalds, for example, competes head to head with other fast food restaurants in the fast food restaurant industry.

*Examining the general environment involves gaining an understanding of key factors and trends in broader society. PESTEL analysis is a popular framework for organizing these factors and trends and isolating how they influence industries and the firms within them. Below we describe each of the six dimensions associated with PESTEL analysis: political, economic, socio-cultural, technological, environmental, and legal.*

**Table 3.1 PESTEL Framework**

| | |
|---|---|
| **P** | **Political** factors include elements such as tax policies, changes in trade restrictions and tariffs, and the stability of governments. |
| **E** | **Economic** factors include elements such as interest rates, inflation rates, gross domestic product, unemployment rates, levels of disposable income, and the general growth or decline of the economy. |
| **S** | **Socio-cultural** factors include trends in demographics such as population size, age, and ethnic mix, as well as cultural trends such as attitudes toward obesity and consumer activism. |
| **T** | **Technological** factors include, for example, changes in the rate of new product development, increases in automation, and advancements in service industry delivery. |
| **E** | **Environmental** factors, also called ecological factors, include, for example, natural disasters, global warming, pollution, and weather patterns. |
| **L** | **Legal** factors include laws involving issues such as employment, health and safety, discrimination, and antitrust. |

## P is for "Political"

The political segment centers on the role of governments in shaping business. This segment includes elements such as tax policies, changes in trade restrictions and tariffs, and the stability of governments (Table 3.2). Stated differently, the political segment consists of the way that the government is involved in the economy or an industry. Immigration policy is an aspect of the political segment of the general environment that offers important implications for many different organizations. For example, how to approach migrant labor in the United States has been a hotly debated dilemma. Some hospital executives have noted that immigrants lacking legal status put a strain on the healthcare system because these immigrants seldom can pay for medical services, and hospitals by law cannot turn them away from emergency rooms. However, many industries, such as hospitality, construction, and agriculture to name a few, rely heavily on migrant labor in its many forms, so political forces directly impact an industry's ability to thrive.

*Examples of several key trends representing political factors in the general environment are illustrated below.*

**Table 3.2 Political Factors**

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| The extent to which companies developing clean energy sources should be subsidized by the government versus being left on their own to compete with providers of traditional energy sources is currently a hotly contested political issue. |
| The use of child labor was once commonplace in the United States. Now, firms face political scrutiny when using overseas suppliers that employ child labor. |
| The word tariff is derived from an Arabic word meaning "fees to be paid." By levying tariffs and implementing other trade restrictions, governments can—to some extent—protect domestic firms from international competition. |
| The stability of the US government provides a source of confidence for foreign firms who want to do business in the United States. Countries that face frequent regime change and political turmoil have a harder time attracting foreign investments. |
| One of the most important duties of elected officials in the United States is to debate and set new tax policies. |


*Figure 3.3: Proposals to provide support for businesses are often featured within political campaigns.*

For example, farmers argue that the current US immigration policy is harmful because it impedes their ability to reliably get the work visas necessary each year to employ the critical mass of migrant labor required to effectively and affordably harvest their crops. In particular, if farmers were forced to employ only workers with preexisting legal status, the cost of produce would increase substantially because of a rise in the cost of wages and the inevitable labor shortage to harvest the crops. Restaurant chains such as Panera would pay higher prices for lettuce, tomatoes, and other perishables. As a result, Panera would have to decide whether to absorb these costs or pass them along to customers by charging more for sandwiches. Overall, any changes in immigration policy will have implications for hospitals, farmers, restaurants, and many other industries.

## E is for "Economic"

The economic segment centers on the economic conditions within which organizations operate. It includes elements such as interest rates, inflation rates, gross domestic product, unemployment rates, levels of disposable income, and the general growth or decline of the economy (Table 3.3). The world-wide economic crisis of 2020 created by COVID-19 had a tremendous negative effect on a vast array of organizations. Rising unemployment discouraged consumers from purchasing expensive, nonessential goods such as automobiles and television sets. Some businesses that were forced to close drained all their resources and were never able to reopen.

One way to determine if the economic force is strong or weak in an industry is to ask, "If the economy drops, is this industry affected?” If the answer is yes, then the economic force is moderate, if not strong. In the hospital industry, for example, the economic force is weak, as a dropping economy does not have much impact on hospitals. People still need and use healthcare services in a poor economy, paid mostly by insurance.

*Examples of several key trends representing economic factors in the general environment are illustrated below.*

**Table 3.3 Economic Factors**

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| The unemployment rate is the percentage of the labor force actively looking for employment within the last four weeks. During the Great Depression of the 1930s, the United States suffered through an unemployment rate of approximately 25%. In 2020, the unemployment rate hit about 15% due to the COVID-19 pandemic, the highest since the Great Depression (The Washington Post, 2020). |
| Housing starts is an economic indicator that measures the number of houses, apartments, and condos on which new construction has been started. Because construction involves a wide array of industries—concrete, steel, wood, drywall, plumbing, banks, and many others—housing starts are a carefully watched measure of economic conditions. |
| Gross domestic product (GDP) refers to the market value of goods and services within a country produced in a given time period and serves as a rough indicator of a country’s standard of living. The United States has a larger GDP than China, but China has enjoyed a much higher rate of GDP growth in recent years. |
| The Federal Reserve System, commonly referred to as “The Fed”, is the United States’ central banking system. The Fed attempts to strengthen the economy through its decisions, such as setting short-term interest rates. |
| Discretionary income refers to the amount of money individuals have to spend after all necessary bills are paid. As discretionary income increases, firms such as boutique clothing retailers that sell nonessential goods and services are more likely to prosper. |

Some businesses, however, actually prospered during the COVID-19 crisis. Retailers that offer deep discounts, such as Dollar General and Walmart, enjoyed an increase in their customer base as consumers sought to find ways to economize. Grocery stores like Kroger and providers of personal protective equipment (PPE) also saw their sales increase significantly.

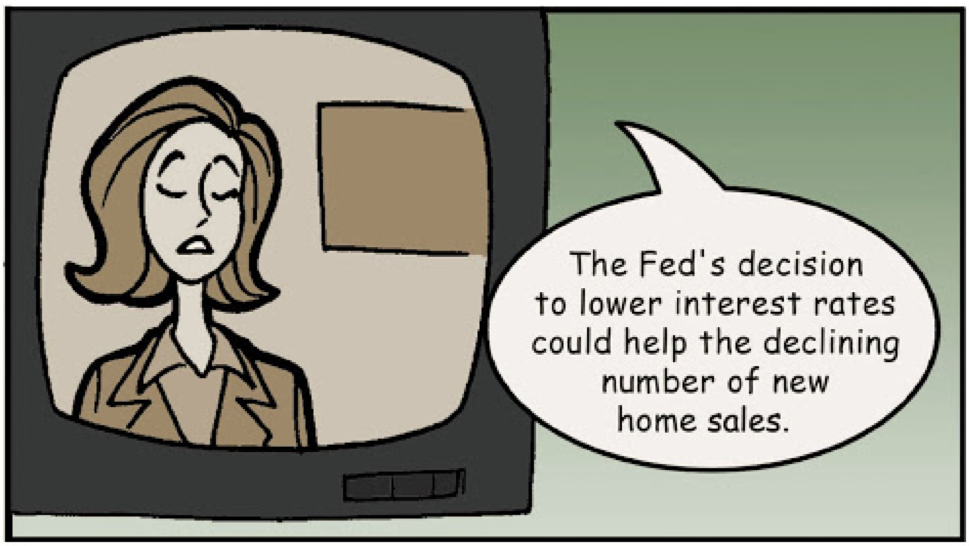


*Figure 3.4: Decisions about interest rates made by the Federal Reserve create opportunities for some organizations and threats for others.*

## S is for "Socio-cultural"

A generation ago, ketchup was an essential element of every American pantry and salsa was a relatively unknown product. Today, however, food manufacturers sell more salsa than ketchup in the United States. This change reflects the socio-cultural segment of the general environment. Socio-cultural factors include trends in demographics such as population size, age, and ethnic mix, as well as cultural trends such as attitudes toward obesity and consumer activism (Table 3.4). The exploding popularity of salsa and other Hispanic foods reflects the increasing number of Latinos in the United States, as well as the growing acceptance of Latino food by other ethnic groups.

*Examples of several key trends representing social factors in the general environment are illustrated below.*

**Table 3.4 Socio-cultural Factors**

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| The rise of upscale cupcake outlets reflects a current trend in American eateries: pricey specialty stores are very popular among some consumers. |
| In the 1800s, most American couples raised many children. Farmers, for example, took this approach because of the high infant mortality rate, and children provided an important source of labor that small, family farms needed in order to operate. Today, most families are smaller. |
| The obesity rate in America, in 2020 was 40%, up from 30.5% in 2000, due in part to the increasing prevalence of fast-food restaurants and the popularity of sedentary activities such as playing video games (Galvin, 2020). |
| Hemline theory contends that women's skirt lengths predict stock market increases and declines. The idea was born in the 1920s when economist George Taylor noticed that many women raised their skirts to reveal their silk stockings when times were good, but lowered their skirts to hide the fact that they weren't wearing stockings when times were tough. |
| The tendency to collect material items while being reluctant to throw them away has led to a rise in self-storage outlets as well as awareness of a hoarding epidemic. |

Sometimes changes in the social segment arise from unexpected sources. Before World War II, the American workforce was overwhelmingly male. When millions of men were sent to Europe and Asia to fight in the war, however, organizations had no choice but to rely heavily on female employees. At the time, the attitudes of many executives toward women were appalling. Consider, for example, some of the advice provided to male supervisors of female workers in the July 1943 issue of *Transportation Magazine*:

- Older women who have never contacted the public have a hard time adapting themselves and are inclined to be cantankerous and fussy. It's always well to impress upon older women the importance of friendliness and courtesy.
- General experience indicates that "husky" girls—those who are just a little on the heavy side—are more even tempered and efficient than their underweight sisters.
- Give every girl an adequate number of rest periods during the day. You have to make some allowances for feminine psychology. A girl has more confidence and is more efficient if she can keep her hair tidied, apply fresh lipstick and wash her hands several times a day.

The tremendous contributions of female workers during the war contradicted these awful stereotypes. The main role of women who assembled airplanes, ships, and other war materials was to support the military, of course, but their efforts also changed some male executives' minds about what females could accomplish within organizations if provided with opportunities. When men returned from the war, women were largely displaced from their jobs. Inequities in the workplace are still pervasive today, but modern attitudes among men toward women in the workplace are much more enlightened than they were in 1943. Nevertheless, as a strategic decision maker, it is important to note that socio-cultural trends like these take many decades to change significantly.

The trend toward widespread acceptance of women into the US workforce has created important opportunities for certain organizations. Retailers such as Talbot's and Dillard's developed new markets for selling business attire to women. Subway and other restaurants benefit when the scarceness of time leads dual income families to purchase take-out meals rather than cook at home.


*Figure 3.5: Women's immense contributions to the war effort during World War II helped create positive social changes in the ensuing decades.*

*Figure 3.6: A surprising demographic trend is that both China and India have more than twice as many English-speaking college graduates each year than does the United States.*

## T is for "Technological"

The technological segment centers on improvements in products and services that are provided by science. Relevant factors include, for example, changes in the rate of new product development, increases in automation, and advancements in service industry delivery (Table 3.5). One key feature of the modern era is the ever-increasing pace of technological innovation. In 1965, Intel co-founder Gordon E. Moore offered an idea that has come to be known as Moore's law. Moore's law suggests that the performance of microcircuit technology roughly doubles every two years. This law has been very accurate in the decades since it was offered.

*Examples of several key trends representing technological factors in the general environment are illustrated below.*

**Table 3.5 Technological Factors**

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| The adoption rate of new technology is closely monitored by market research firms. The internet reached 50 million users in 4 years. To reach the same number of users took 13 years for TV and 38 years for radio. |
| Online shopping has transformed the retail market. Failure to successfully compete against Amazon has forced long-stable retailers like Sears, JCPennys, KMart, and Neiman Marcus to close stores or shut down all together. |
| The dramatic changes in the video game industry over the past 25 years highlight the need to constantly adapt to technological factors to maintain market leadership. Once-mighty Atari has given way to current leaders Sony, Nintendo, and Microsoft. |
| The popularity of smartphones has greatly changed how some businesses operate. |
| The marketing of many products and services has been transformed because of social media. |

*Figure 3.7: Moore's law explains how today's iPhone can be one hundred times faster, one hundred times lighter, and ten times less expensive than a "portable" computer built in the 1980s.*

One implication of Moore's law is that over time electronic devices can become smaller but also more powerful. This creates important opportunities and threats in a variety of settings. Consider, for example, photography. Just a decade ago, digital cameras were popular and rather inexpensive. With the exception of high-end and action cameras, cell phone cameras have largely replaced digital cameras, which had replaced film cameras the decade before.

## E is for "Environmental" or "Ecological"

The environmental segment involves the physical and ecological conditions within which organizations operate. It includes factors such as natural disasters, pollution levels, global warming, and weather patterns (Table 3.6). The threat of pollution, for example, has forced municipalities to treat water supplies with chemicals. These chemicals increase the safety of the water but detract from its taste. This has created opportunities for businesses that provide better-tasting water. Rather than consume cheap but bad-tasting tap water, many consumers purchase bottled water. Global warming has created the need to restrict greenhouse gases by reducing the burning of fossil fuels. The electric car industry is a result of this environmental force. Most all automobile manufacturers have electric cars as part of their product lines.

*Examples of several key trends representing environmental/ecological factors in the general environment are illustrated below.*

**Table 3.6 Environmental Factors**

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| The Subaru automotive plant in Lafayette, Indiana was the first auto manufacturing facility to achieve zero landfill status. |
| The increased number of solar energy companies and use of solar panels is a direct result of climate change. |
| Individuals embracing the three Rs of green living–reduce, reuse, recycle–has fueled new business concepts such as Recycle Match, a firm that brings together waste products with businesses that need those materials. |
| Concern about the environmental effects of burning fossil fuels has contributed to the growing popularity of electric scooters. |
| The increase in the number of food cooperatives reflects growing interest in sustainable, natural foods that are produced with a high degree of social responsibility. |

*Figure 3.8: A key trend within the environmental segment is an increasing emphasis on conserving fossil fuels.*

As is the case for many companies, bottled water producers not only have benefited from the general environment but also have been threatened by it. Some estimates are that 80% of plastic bottles end up in landfills. This has led some socially conscious consumers to become hostile to bottled water. Meanwhile, water filtration systems offered by Brita and other companies are a cheaper way to obtain clean and tasty water. Such systems also hold considerable appeal for individuals who feel the need to cut personal expenses due to economic conditions. In sum, bottled water producers have been provided opportunities by the environmental segment of the general environment, specifically, the spread of poor-tasting water to combat pollution, but are faced with threats from the socio-cultural segment, the social conscience of some consumers, and the economic segment, the financial concerns of other consumers. The ecological trend toward reducing greenhouse gases and global warming, has also created opportunities for Elon Musk and Tesla on several fronts. Companies that produce solar panels, lithium-ion batteries, and electric cars are ventures Musk has started, leveraging the ecological forces that makes these products more and more desirable.

## L is for “Legal”

The legal segment centers on how the courts and laws influence business activity. Examples of important legal factors include employment laws, health and safety regulations, discrimination laws, and antitrust laws (Table 3.7).

Some people confuse the political factors with legal ones. The key distinction is that political factors are related to the interactions and relationship between businesses and the government whereas legal factors are the boundary parameters of business activities. For example, a government policy such as a trade restriction between countries would constitute a political factor, not a legal one. Similarly, a law requiring employees to be paid overtime past 40 hours would be a legal factor, not a political one.

Intellectual property rights are a particularly daunting aspect of the legal segment for many organizations. When a studio such as Pixar produces a movie, a software firm such as Adobe revises a program, or a video game company such as Activision devises a new game, these firms are creating intellectual property. Such firms attempt to make profits by selling copies of their movies, programs, and games to individuals. Piracy of intellectual property—a process wherein illegal copies are made and sold by others—poses a serious threat to such profits. Law enforcement agencies and courts in many countries, including the United States, provide organizations with the necessary legal mechanisms to protect their intellectual property from piracy.

*Examples of several key trends representing legal factors in the general environment are illustrated below.*

**Table 3.7 Legal Factors**

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| Electronic recycling laws are creating opportunities for “green collar jobs.” A Missouri law, for example, requires computer electronic equipment manufacturers to develop and implement recycling plans. |
| The Sherman Antitrust Act of 1890 limits cartels and monopolies in the United States. Senator John Sherman was the principal author of this legislation. |
| In the United States, it is illegal to discriminate against anyone based on age, race, religion, sex or disability. |
| The role of the Occupational Safety and Health Administration (OSHA) is to prevent work-related injuries, diseases, and fatalities by enforcing standards for workplace safety and health. |
| Laws requiring that nutrition information must appear on the packaging of most food products are intended to protect consumers and help them make informed choices. |

In other countries, such as China, piracy of intellectual property is quite common. Three other general environment segments play a role in making piracy a major concern. First, in terms of the socio-cultural segment, China is the most populous country in the world. Second, in terms of the economic segment, China’s affluence is growing rapidly. Third, in terms of the technological segment, rapid advances in computers and communication have made piracy easier over time. Taken together, these various general environment trends lead piracy to be a major source of angst for firms that rely on intellectual property to deliver profits.


*Figure 3.9: A key legal trend in recent years is forcing executives to have greater accountability for corporate misdeeds via laws such as the 2002 Sarbanes-Oxley Act.*

## *Key Takeaway*

- PESTEL is a framework that reflects general environmental factors—political, economic, socio-cultural, technological, environmental, and legal—that can impact an organization either positively or negatively. In many cases, executives can prevent negative outcomes and leverage positive forces by performing a PESTEL analysis to diagnose where in the general environment important opportunities and threats arise.

*Exercises*

1. What does each letter of PESTEL mean?
2. Using a recent news article, identify a trend that has a positive and negative implication for a particular industry.
3. Can you identify a general environment trend that has positive implications for nursing homes but negative implications for diaper makers?
4. Are all six elements of PESTEL important to every organization? Why or why not?
5. What is a key trend for each letter of PESTEL and one industry or firm that would be affected by that trend?

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Figure 3.8: Webster, Tony. “Spin Shared Electric Scooters.” CC BY 2.0. Cropped. Retrieved from https://www.flickr.com/photos/diversey/46775872844.

# 3.4 Evaluating the Industry

## The Purpose of Five Forces Analysis

*Understanding the dynamics that shape how much profit potential exists within an industry is key to knowing how likely a particular firm is to succeed within the industry. There are five key forces that determine the profitability of a particular industry. Taken together, all five forces indicate the attractiveness of an industry. Attractive industries—those with favorable conditions—are more likely to experience higher profitability.*

**Table 3.8 Porter's Five Forces**

| Industry Analysis: Porter's Five Forces |
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| **Threat of potential entrants** are firms that are not currently considered viable competitors in the industry but that may become viable competitors in the future. For example, Tesla Motors' production of electric vehicles poses a threat to displace the traditional powers in the auto industry, and Chinese automakers are rumored to be eyeing the US market. |
| **Bargaining power of suppliers** to the auto industry include firms such as Lear Corporation who produces auto interior systems. |
| **Rivalry of industry competitors** in the auto industry include firms such as Ford, Fiat Chrysler, and GM. |
| **Bargaining power of buyers** are those firms that buy directly from the industry such as automobile dealerships. Automakers also have to pay careful attention to end users, of course, such as individual drivers and rental car agencies. |
| **Threat of substitutes** for the auto industry's products include bicycles and mass transit. Luckily for automakers competing in the US market, Americans are notoriously reluctant to embrace these substitutes. |

Visit the executive suite of any company and the chances are very high that the chief executive officer and her vice presidents are relying on Five Forces Analysis to understand their industry. Introduced more than thirty years ago by Professor Michael Porter of the Harvard Business School, Five Forces Analysis has long been and remains perhaps the most popular analytical tool in the business world (Table 3.8).

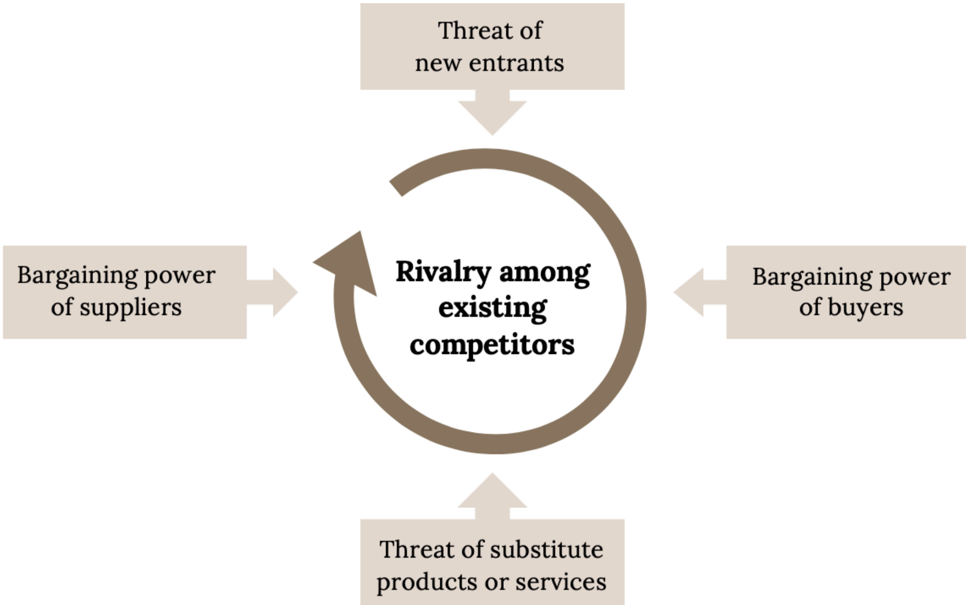


*Figure 3.10: Porter's Five Forces*

The purpose of Five Forces Analysis is to identify how much profit potential exists in an industry. To do so, Five Forces Analysis considers the interactions among the competitors in an industry, potential new entrants to the industry, substitutes for the industry's offerings, suppliers to the industry, and the industry's buyers (Porter, 1979). If none of these five forces works to undermine profits in the industry, then the profit potential is very strong. If all the forces work to undermine profits, then the profit potential is very weak. Most industries lie somewhere in between these extremes. This could involve, for example, all five forces providing firms with modest help or two forces encouraging profits while the other three undermine profits. Once executives determine how much profit potential exists in an industry, they can then decide what strategic moves to make to be successful. If the situation looks bleak, for example, one possible move is to exit the industry.

## The Rivalry among Competitors in an Industry

The competitors in an industry are firms that produce similar products or services. Competitors use a variety of moves such as advertising, new offerings, and price cuts to try to outmaneuver one another to retain existing buyers and to attract new ones. Because competitors seek to serve the same general set of buyers, rivalry can become intense (Table 3.9). Subway faces fierce competition within the restaurant business, for example. This is illustrated by a quote from the man who built McDonald's into a worldwide icon. Former CEO Ray Kroc allegedly once claimed that "if any of my competitors were drowning, I'd stick a hose in their mouth." While this sentiment was (hopefully) just a figure of speech, the announcement in March 2011 that Subway had surpassed McDonald's in terms of numbers of stores, this intense rivalry has led to Subway having 10,000 more stores world-wide than McDonald's in 2020.

*High levels of rivalry tend to reduce the profit potential of an industry. A number of characteristics that affect the intensity of the rivalry among competitors are illustrated below.*

**Table 3.9 Rivalry**

| **Rivalry among existing competitors tends to be high to the extent that…** | |
|---|---|
| **Competitors are numerous or are roughly equal in size and power.** | No one firm rules the industry, and cutthroat moves are likely as firms jockey for position. |
| **The growth rate of the industry is slow.** | A shortage of new customers leads firms to steal each other's customers. |
| **Competitors are not differentiated from each other.** | This forces firms to compete based on price rather than based on the uniqueness of their offerings. |
| **Fixed costs in the industry are high.** | These costs must be covered, even if it means slashing prices in order to do so. |
| **Exit barriers are high.** | Firms must stay and fight rather than leaving the industry gracefully. |
| **Excess capacity exists in the industry.** | When too much of a product is available, firms must work hard to earn sales. |
| **Capacity must be expanded in large increments to be efficient.** | The high costs of adding these increments needs to be covered. |
| **The product is perishable** | Firms need to sell their wares before they spoil and become worthless. |

Understanding the intensity of rivalry among an industry's competitors is important because the degree of intensity helps shape the industry's profit potential. Of particular concern is whether firms in an industry compete based on price. When competition is bitter and cutthroat, the prices competitors charge—and their profit margins—tend to go down. If, on the other hand, competitors avoid bitter rivalry, then price wars can be avoided and profit potential increases.

Every industry is unique to some degree, but there are some general characteristics that help to predict the likelihood that fierce rivalry will erupt. Rivalry tends to be fierce, for example, to the extent that the growth rate of demand for the industry's offerings is low (because a lack of new customers forces firms to compete more for existing customers), fixed costs in the industry are high (because firms will fight to have enough customers to cover these costs), competitors are not differentiated from one another (because this forces firms to compete based on price rather than based on the uniqueness of their offerings), and exit barriers in the industry are high (because firms do not have the option of leaving the industry gracefully). Exit barriers can include emotional barriers, such as the bad publicity associated with massive layoffs, or more objective reasons to stay in an industry, such as a desire to recoup considerable costs that might have been previously spent to enter and compete.

Industry concentration is an important aspect of competition in many industries. Industry concentration is the extent to which a small number of firms dominate an industry (Table 3.10). Among circuses, for example, the four largest companies collectively own 89% of the market. Meanwhile, these companies tend to keep their competition rather polite. Their advertising does not lampoon one another, and they do not put on shows in the same city at the same time. This does not guarantee that the circus industry will be profitable; there are four other forces to consider as well as the quality of each firm's strategy. But low levels of rivalry certainly help build the profit potential of the industry.

In contrast, the restaurant industry is fragmented, meaning that the largest rivals control just a small fraction of the business and that a large number of firms are important participants. Rivalry in fragmented industries tends to become bitter and fierce. Quiznos, a chain of sub shops that is roughly 15% the size of Subway, has directed some of its advertising campaigns directly at Subway, including one depicting a fictional sub shop called "Wrong Way" that bore a strong resemblance to Subway.

Within fragmented industries, it is almost inevitable that over time some firms will try to steal customers from other firms, such as by lowering prices, and that any competitive move by one firm will be matched by others. In the wake of Subway's success in offering foot-long subs for $5, for example, Quiznos has matched Subway's price. Such price jockeying is delightful to customers, of course, but it tends to reduce prices, and profit margins) within an industry. Indeed, Quiznos later escalated its attempt to attract budget-minded consumers by introducing a flatbread sandwich that cost only $2. Overall, when choosing strategic moves, Subway's presence in a fragmented industry forces the firm to try to anticipate not only how fellow restaurant giants such as McDonald's and Burger King will react but also how smaller sub shop chains like Quiznos and various regional and local players will respond.

*Industry concentration refers to the extent to which large firms dominate an industry. Buyers and suppliers generally have more bargaining power when they are from concentrated industries. This is because the firms that do business with them have fewer options when seeking buyers and suppliers. One popular way to measure industry concentration is via the percentage of total industry output that is produced by the four biggest competitors. Below are examples of industries that have high (80%-100%), medium (50%-79%), and low (below 50%) levels of concentration.*

**Table 3.10 Industry Concentration**

| **High-Concentration Industries** |
| --- |
| Circuses (89%) and breakfast cereal manufacturing (85%) |
| **Medium-Concentration Industries** |
| Flight training (52%) and sugar manufacturing (60%) |
| **Low-Concentration or "Fragmented" Industries** |
| Full-service restaurants (9%), Legal services (3%), Truck driving schools (27%), and Telephone call centers (22%) |

## The Threat of Potential New Entrants to an Industry

Competing within a highly profitable industry is desirable, but it can also attract unwanted attention from outside the industry. Potential new entrants to an industry are firms that do not currently compete in the industry but may in the future (Table 3.11). New entrants tend to reduce the profit potential of an industry by increasing its competitiveness. If, for example, an industry consisting of five firms is entered by two new firms, this means that seven rather than five firms are now trying to attract the same general pool of customers. Thus, executives need to analyze how likely it is that one or more new entrants will enter their industry as part of their effort to understand the profit potential that their industry offers.


*Figure 3.11: The entry of chicken burger restaurant Oporto into the United States might hurt hamburger restaurants more than it hurts Subway and other sandwich makers.*

New entrants can join the fray within an industry in several different ways. New entrants can be start-up companies created by entrepreneurs, foreign firms that decide to enter a new geographic area, supplier firms that choose to enter their customers' business, or buyer firms that choose to enter their suppliers' business. The likelihood of these four paths being taken varies across industries. Restaurant firms such as Subway, for example, do not need to worry about their buyers entering the industry because they sell directly to individuals, not to firms. It is also unlikely that Subway's suppliers, such as farmers, will make a big splash in the restaurant industry.

On the other hand, entrepreneurs launch new restaurant concepts every year, and one or more of these concepts may evolve into a fearsome competitor. Also, competitors based overseas sometimes enter Subway's core US market. In February 2011, Australia-based Oporto opened its first US store in California (Odell, 2011). Oporto operates more than 130 chicken burger restaurants in its home country. But Oporto didn't survive in the US, and closed its US stores in 2013.

Every industry is unique to some degree, but some general characteristics help to predict the likelihood that new entrants will join an industry. New entry is less likely, for example, to the extent that existing competitors enjoy economies of scale (because new entrants struggle to match incumbents' prices), capital requirements to enter the industry are high (because new entrants struggle to gather enough cash to get started), access to distribution channels is limited (because new entrants struggle to get their offerings to customers), governmental policy discourages new entry, differentiation among existing competitors is high (because each incumbent has a group of loyal customers that enjoy its unique features), switching costs are high (because this discourages customers from buying a new entrant's offerings), expected retaliation from existing competitors is high, and cost advantages independent of size exist.

*The Great Wall of China effectively protected China against potential raiders for centuries. The metaphor of a high wall as a defense against potential entrants is a key element in Porter's Five Forces model. Industries with higher barriers to entry are in a safer defensive position than industries with lower barriers. Below we describe several factors that make it difficult for would-be invaders to enter an industry.*

**Table 3.11 New Entrants**

| | |
|---|---|
| **Economies of scale** | As the number of customers a firm serves increases, the cost of serving each customer tends to decrease. This is because fixed costs—the expenses the firm must pay, such as the loan payments on an automobile factory—are allocated across a larger number of sales. When the firms in an industry enjoy significant economies of scale, new firms struggle to be able to sell their wares at competitive prices. |
| **Capital requirements** | The more expensive it is to enter a business, the less likely a new firm is to attempt to enter it. When these capital requirements are substantial, as in the automobile and many other manufacturing industries, existing competitors have less fear of new firms entering their market. It is simply very difficult to gather up enough cash to enter certain businesses. |
| **Access to distribution channels** | The ability to get goods and services to customers can pose a significant challenge to would-be newcomers. In the auto industry, for example, a new firm would struggle to match the network of dealerships enjoyed by Ford, GM, and other automakers. |
| **Government policy** | Decisions made by governments can deter or encourage potential new entrants. In 2009, the US government kept GM afloat via a massive infusion of cash. Had GM been left to die instead, this could have opened the door for a new company to enter the industry, perhaps by buying some of GM's factories. |
| **Differentiation** | Automakers spend millions of dollars each year on advertising in order to highlight the unique features of their cars. A new entrant would struggle to match the differentiation that years of advertising have created for various brands. |
| **Switching costs** | Switching costs endured by consumers are one of the challenges facing the makers of alternative fuel vehicles. A massive number of gas stations and repair shops are in place to support gasoline-powered cars, but few facilities can recharge or fix electric cars. At present, few consumers are willing to live with the significant hassles and inconvenience that arise when purchasing an alternative fuel vehicle. |
| **Expected retaliation** | New firms must be concerned about whether current industry members will aggressively respond to them entering the market. If a firm succeeded in entering the automobile business, for example, existing companies might slash their prices in order to keep their market share intact. |
| **Cost advantages independent of size** | Proprietary technology, access to raw materials, and desirable geographic location are all examples of cost advantages not directly associated with size and economies of scale. In the auto industry, the decades of engineering experience possessed by the major auto markers is an example of such an advantage. A new entrant would struggle to duplicate this know-how at any price. |

## The Threat of Substitutes for an Industry's Offerings

Executives need to take stock not only of their direct competition but also of players in other industries that can steal their customers. Substitutes are offerings that differ from the goods and services provided by the competitors in an industry but that fill similar needs to what the industry offers (Table 3.12). How strong of a threat substitutes are depends on how effective substitutes are in serving an industry's customers.

At first glance, it could appear that the satellite television business is a tranquil one because there are only two significant competitors in the US: DIRECTV and DISH Network. These two industry giants, however, face a daunting challenge from substitutes. The closest substitute for satellite television is provided by cable television firms, such as Comcast and Charter Communications. DIRECTV and DISH Network also need to be wary of streaming video services, such as Netflix, and video rental services, such as Redbox. The availability of viable substitutes places stringent limits on what DIRECTV and DISH Network can charge for their services. If the satellite television firms raise their prices, customers will be tempted to obtain video programs from alternative sources. This limits the profit potential of the satellite television business.

In other settings, viable substitutes are not available, and this helps an industry's competitors enjoy profits. Like light bulbs, candles can provide lighting within a home. Few consumers, however, would be willing to use candles instead of light bulbs. Candles simply do not provide as much light as light bulbs. Also, the risk of starting a fire when using candles is far greater than the fire risk of using light bulbs. Because candles are a poor substitute, light bulb makers such as Sylvania and Phillips do not need to fear candle makers stealing their customers and undermining their profits.

*Figure 3.12: Few consumers would be willing to substitute candles for light bulbs.*

The dividing line between which firms are competitors and which firms offer substitutes is a challenging issue for executives. Most observers would agree that, from Subway's perspective, sandwich maker Quiznos should be considered a competitor and that grocery stores such as Kroger offer a substitute for Subway's offerings. But what about full-service restaurants, such as Ruth's Chris Steak House, and "fast casual" outlets, such as Panera Bread? Whether firms such as these are considered competitors or substitutes depends on how the industry is defined. Under a broad definition—Subway competes in the restaurant business—Ruth's Chris and Panera should be considered competitors. Under a narrower definition—Subway competes in the sandwich business—Panera is a competitor and Ruth's Chris is a substitute. Under a very narrow definition—Subway competes in the sub sandwich business—both Ruth's Chris and Panera provide substitute offerings. Thus clearly defining a firm's industry is an important step for executives who are performing a Five Forces Analysis.

*A substitute teacher is a person who fills in for a teacher. Some substitute teachers are almost as good as the "real" teacher while others are woefully inadequate. In business, the competitors in an industry not only must watch each other, they must keep an eye on firms in other industries whose products or services can serve as effective substitutes for their offerings. In some cases, substitutes are so effective that they are said to "disrupt" the industry, meaning they kill most or all industry demand. Below we note a number of effective substitutes for particular industries.*

**Table 3.12 Substitutes**

| **Substitutes in Different Industries** |
|---|
| Cooking at home can be an effective substitute for eating at restaurants, especially in challenging economic times. |
| Emails and faxes are less expensive substitutes for some of the US Postal Service's offerings. Meanwhile, text messages can serve as substitutes for many emails. |
| Typewriting classes were once common in schools. But once personal computers and printers became widely accepted, the typewriter industry declined dramatically. |
| Railroads once held almost a monopoly position on freight transportation. However, the rise of the trucking industry reduced demand for the railroad industry's services. |
| DIRECTV's commercials compare the firm's offerings not only to what its fellow satellite television provider DISH Network provides but also to the offerings of a close substitute—cable television companies. |

## The Power of Suppliers to an Industry

Suppliers provide inputs that the firms in an industry need to create the goods and services that they in turn sell to their buyers. A variety of supplies are important to companies, including raw materials, financial resources, and labor (Table 3.13). For restaurant firms such as Subway, key suppliers include such firms as Sysco that bring various foods to their doors, restaurant supply stores that sell kitchen equipment, and employees that provide labor.

The relative bargaining power between an industry's competitors and its suppliers help shape the profit potential of the industry. If suppliers have greater leverage over the competitors than the competitors have over the suppliers, then suppliers can increase their prices over time. This cuts into competitors' profit margins and makes them less likely to be prosperous. On the other hand, if suppliers have less leverage over the competitors than the competitors have over the suppliers, then suppliers may be forced to lower their prices over time. This strengthens competitors' profit margins and makes them more likely to be prosperous. Thus when analyzing the profit potential of their industry, executives must carefully consider whether suppliers have the ability to demand higher prices.

Every industry is unique to some degree, but some general characteristics help to predict the likelihood that suppliers will be powerful relative to the firms to which they sell their goods and services. Suppliers tend to be powerful, for example, to the extent that the suppliers' industry is dominated by a few companies, if it is more concentrated than the industry that it supplies and/or if there is no effective substitute for what the supplier group provides. These circumstances restrict industry competitors' ability to shop around for better prices and put suppliers in a position of strength.

Supplier power is also stronger to the extent that industry members rely heavily on suppliers to be profitable, industry members face high costs when changing suppliers, and suppliers' products are differentiated. Finally, suppliers possess power to the extent that they have the ability to become a new entrant to the industry if they wish. This is a strategy called forward vertical integration. Ford, for example, used a forward vertical integration strategy when it purchased rental car company and Ford customer, Hertz. A difficult financial situation forced Ford to sell Hertz for $5.6 billion 11 years later. But before rental car companies such as Avis and Thrifty drive too hard of a bargain when buying cars from an automaker, their executives should remember that automakers are much bigger firms than are rental car companies. The executives running the automaker might simply decide that they want to enjoy the rental car company's profits themselves and acquire the firm.

*A number of characteristics that impact the power of suppliers to a given industry are illustrated below.*

**Table 3.13 Power of Suppliers**

| Power of Suppliers | Example |
|---|---|
| A supplier group is powerful if it is dominated by a few companies or is more concentrated than the industry that it supplies. | The DeBeers Company of South Africa owns the vast majority of diamond mines in the world. This gives the firm great leverage when negotiating with various jewelry producers. |
| A supplier group is powerful if there is no substitute for what the supplier group provides. | Although artificial diamonds are fine for industrial applications, real diamonds are necessary for jewelry. Any groom who thinks otherwise is playing a risky game indeed. |
| A supplier group is powerful if industry members rely heavily on suppliers to be profitable. | Computer, cellular phone, and digital appliance manufacturers all rely heavily on suppliers in the microchip manufacturing industry. |
| A supplier group is powerful if industry members face high costs when changing suppliers. | Most computers installed in university classrooms are PCs. A university that wants to switch to using Apple computers would endure enormous costs in money and labor. This strengthens the position of PC makers a bit when they deal with universities. |
| A supplier group is powerful if their products are differentiated. | Dolby Laboratories offers top-quality audio systems that are backed by a superb reputation. Firms that make home theater equipment and car stereos have little choice but to buy from Dolby because many consumers simply expect to enjoy Dolby's technology. |
| A supplier group is powerful if it can credibly threaten to compete (integrate forward) in the industry if motivated. | Before a rental car company drives too hard of a bargain when buying cars from an auto maker, it should remember that Ford used to own Hertz. |

## Strategy at the Movies

*Flash of Genius*

When dealing with a large company, a small supplier can get squashed like a bug on a windshield. That is what college professor and inventor Dr. Robert Kearns found out when he invented intermittent windshield wipers in the 1960s and attempted to supply them to Ford Motor Company. As depicted in the 2008 movie *Flash of Genius*, Kearns dreamed of manufacturing the wipers and selling them to Detroit automakers. Rather than buy the wipers from Kearns, Ford replicated the design. An angry Kearns then spent many years trying to hold the firm accountable for infringing on his patent. Kearns eventually won in court, but he paid a terrible personal price along the way, including a nervous breakdown and estrangement from his family. Kearns's lengthy battle with Ford illustrates the concept of bargaining power that is central to Porter's Five Forces model. Even though Kearns created an exceptional new product, he had little leverage when dealing with a massive, well-financed automobile manufacturer.

*What did Henry Ford II Steal from a common man | One man fought the might of Ford Motors and won!* [01:52]

This video is about Robert Kearns taking on Ford.

You can view this video here: https://youtu.be/iroEVFDZOHI.

## The Power of an Industry's Buyers

Buyers purchase the goods and services that the firms in an industry produce (Table 3.14). For Panera Bread and other restaurants, buyers are individual people. In contrast, the buyers for some firms are other firms rather than end users. For Procter & Gamble, for example, buyers are retailers such as Walmart and Target who stock Procter & Gamble's pharmaceuticals, hair care products, pet supplies, cleaning products, and other household goods on their shelves.

*Figure 3.13: College students' lack of buyer power in the textbook industry has kept prices high for decades and created frustration for students.*

The relative bargaining power between an industry's competitors and its buyers helps shape the profit potential of the industry. If buyers have greater leverage over the competitors than the competitors have over the buyers, then the competitors may be forced to lower their prices over time. This weakens competitors' profit margins and makes them less likely to be prosperous. Walmart furnishes a good example. The mammoth retailer is notorious among manufacturers of goods for demanding lower and lower prices over time (Bianco & Zellner, 2003). In 2008, for example, the firm threatened to stop selling compact discs if record companies did not lower their prices. Walmart has the power to insist on price concessions because its sales volume is huge. Compact discs make up a small portion of Walmart's overall sales, so exiting the market would not hurt Walmart. From the perspective of record companies, however, Walmart is their biggest buyer. If the record companies were to refuse to do business with Walmart, they would miss out on access to a large portion of consumers.

On the other hand, if buyers have less leverage over the competitors than the competitors have over the buyers, then competitors can raise their prices and enjoy greater profits. This description fits the textbook industry quite well. College students are often dismayed to learn that an assigned textbook costs $150 or more. Historically, textbook publishers have been able to charge high prices because buyers had no leverage. A student enrolled in a class must purchase the specific book that the professor has selected. Used copies are sometimes a lower-cost option, but textbook publishers have cleverly worked to undermine the used textbook market by releasing new editions after very short periods of time.

Of course, the presence of a very high profit industry is attractive to potential new entrants. Firms such as, the publisher of this book, have entered the textbook market with lower-priced offerings. Time will tell whether such offerings bring down textbook prices. Like any new entrant, upstarts in the textbook business must prove that they can execute their strategies before they can gain widespread acceptance. Overall, when analyzing the profit potential of their industry, executives must carefully consider whether buyers have the ability to demand lower prices. In the textbook market, buyers do not.

*A number of characteristics that impact the power of buyers to a given industry are illustrated below.*

**Table 3.14 Power of Buyers**

| **Power of Buyers** | **Example** |
|---|---|
| A buyer group is powerful when there are relatively few buyers compared to the number of firms supplying the industry. | Buyers that purchase a large percentage of the seller's goods and services are more powerful, as Walmart has demonstrated by aggressively negotiating with suppliers over the years. |
| A buyer group is powerful when the industry's goods or services are standardized or undifferentiated. | Subway can drive a hard bargain when purchasing commodities such as wheat and yeast since both are typically identical to another vendor's. |
| A buyer group is powerful when they face little or no switching costs in changing vendors. | Circuses can find elephants, clowns, and trapeze artists from any source possible. This allows circus managers to shop around for the best prices. |
| A buyer group is powerful when the good or service purchased by the buyers represents a high percentage of the buyer's costs, encouraging ongoing searches for lower-priced suppliers. | Most consumers pay little attention to prices when buying toothpaste, but may spend hours exhaustively searching the internet for information on automobile prices. |
| A buyer group is powerful if it can credibly threaten to compete (integrate backward) in the industry if motivated. | Ford and General Motors are well known for threatening to self-manufacture auto parts if suppliers do not provide goods and services at acceptable prices. |
| A buyer group is powerful when the good or service purchased by buyer groups is of limited importance to the quality or price of the buyer's offerings. | While stereo systems and tires are components that car buyers may be sensitive to when making a purchase decision, auto manufacturers can purchase glass and spark plugs from any vendor as long as it meets quality standards. This gives automakers leverage when negotiating with glass and spark plugs companies. |

Every industry is unique to some degree, but some general characteristics help to predict the likelihood that buyers will be powerful relative to the firms from which they purchase goods and services. Buyers tend to be powerful, for example, to the extent that there are relatively few buyers compared with the number of firms that supply the industry, the industry's goods or services are standardized or undifferentiated, buyers face little or no switching costs in changing vendors, the good or service purchased by the buyers represents a high percentage of the buyer's costs, and the good or service is of limited importance to the quality or price of the buyer's offerings.

Finally, buyers possess power to the extent that they have the ability to become a new entrant to the industry if they wish. This strategy is called backward vertical integration. DIRECTV used to be an important customer of TiVo, the pioneer of digital video recorders. This situation changed, however, when executives at DIRECTV grew weary of their relationship with TiVo. DIRECTV then used a backward vertical integration strategy and started offering DIRECTV-branded digital video recorders. Profits that used to be enjoyed by TiVo were transferred at that point to DIRECTV.

## Interpreting the Five Forces

When using Porter's Five Forces tool, it is important to note the strength of each of the five forces that are analyzed. The forces are typically ranked as Strong/High, Moderate/Medium, or Weak/Low. If these competitive forces within an industry are high, then the profit potential in that industry is low. Strong forces indicate high competition for the profits within that industry, making it a less desirable industry to be in. Conversely, if the forces within an industry are generally weak, this indicates a stronger potential for profit and a desirable industry to be in. A mixture of strong and weak forces means there is profit potential, but there exist competitive forces within the industry that can dilute the profit potential. Upon doing Porter's Five Forces Analysis, companies should make an informed decision on entering that market, and how they might compete, given the various strengths of the forces.

## The Limitations of Five Forces Analysis

Five Forces Analysis is useful, but it has some limitations too. The description of Five Forces Analysis provided by its creator, Michael Porter, seems to assume that competition is a zero-sum game, meaning that the amount of profit potential in an industry is fixed. One implication is that if a firm is to make more profit, it must take that profit from a rival, a supplier, or a buyer. In some settings, however, collaboration can create a larger pool of profit that benefits everyone involved in the collaboration. In general, collaboration is a possibility that Five Forces Analysis tends to downplay. The relationships among the rivals in an industry, for example, are depicted as adversarial. In reality, these relationships are sometimes adversarial and sometimes collaborative. General Motors and Toyota compete fiercely all around the world, for example, but they also have worked together in joint ventures. Similarly, Five Forces Analysis tends to portray a firm's relationships with its suppliers and buyers as adversarial, but many firms find ways to collaborate with these parties for mutual benefit. Indeed, concepts such as just-in-time inventory systems depend heavily on a firm working as a partner with its suppliers and buyers.

## Section Videos

*Porter's Five Forces* [02:57]

This video for the lesson explains the Porter's Five Forces Model.

You can view this video here: https://youtu.be/__IaBZmB09RE.

*Porter's Five Forces (Tesla Example)* [09:51]

This video for the lesson works through the Porter's Five Forces analysis using Tesla as an example.

You can view this video here: https://youtu.be/5F0dI8zaotU.

### *Key Takeaway*

- "How much profit potential exists in our industry?" is a key question for executives. Five Forces Analysis provides an answer to this question. It does this by considering the interactions among the competitors in an industry, potential new entrants to the industry, substitutes for the industry's offerings, suppliers to the industry, and the industry's buyers.

### *Exercises*

1. What are the five forces?
2. Is there an aspect of industry activity that the five forces seems to leave out?
3. Imagine you are the president of your college or university. Which of the five forces would be most important to you? Why?

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Figure 3.12: Sugeesh. "A candle lit inside an electric bulb." Public Domain. Retrieved from https://commons.wikimedia.org/wiki/File:Candle_in_Incandescent_light_bulb.png.

Figure 3.13: Grabowska, Karolina. "Person Holding Stack of Books." Pexels License. Retrieved from https://www.pexels.com/photo/person-holding-stack-of-books-4218978.

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# 3.5 Mapping Strategic Groups

## Understanding Strategic Groups

The analysis of the strategic groups in an industry can offer important insights to executives. Strategic groups are sets of firms that follow similar strategies to one another (Hunt, 1972; Short et al., 2007). More specifically, a strategic group consists of a set of industry competitors that have similar characteristics to one another but differ in important ways from the members of other groups (Table 3.15).

Understanding the nature of strategic groups within an industry is important for at least three reasons. First, emphasizing the members of a firm's group is helpful because these firms are usually its closest rivals. When assessing their firm's performance and considering strategic moves, the other members of a group are often the best referents for executives to consider. In some cases, one or more strategic groups in the industry are irrelevant. Subway, for example, does not need to worry about competing for customers with the likes of Ruth's Chris Steak House and P. F. Chang's. This is partly because firms confront mobility barriers that make it difficult or illogical for a particular firm to change groups over time. Because Subway is unlikely to offer a gourmet steak as well as the experience offered by fine dining outlets, they can largely ignore the actions taken by firms in that restaurant industry strategic group.

Second, the strategies pursued by firms within other strategic groups highlight alternative paths to success. A firm may be able to borrow an idea from another strategic group and use this idea to improve its situation. During the recession of the late 2000s, mid-quality restaurant chains such as Applebee's and Chili's used a variety of promotions such as coupons and meal combinations to try to attract budget-conscious consumers. Firms such as Subway and Quiznos that already offered low-priced meals still had an inherent price advantage over Applebee's and Chili's, however: there is no tipping expected at the former restaurants, but there is at the latter. It must have been tempting to executives at Applebee's and Chili's to try to expand their appeal to budget-conscious consumers by experimenting with operating formats that do not involve tipping.

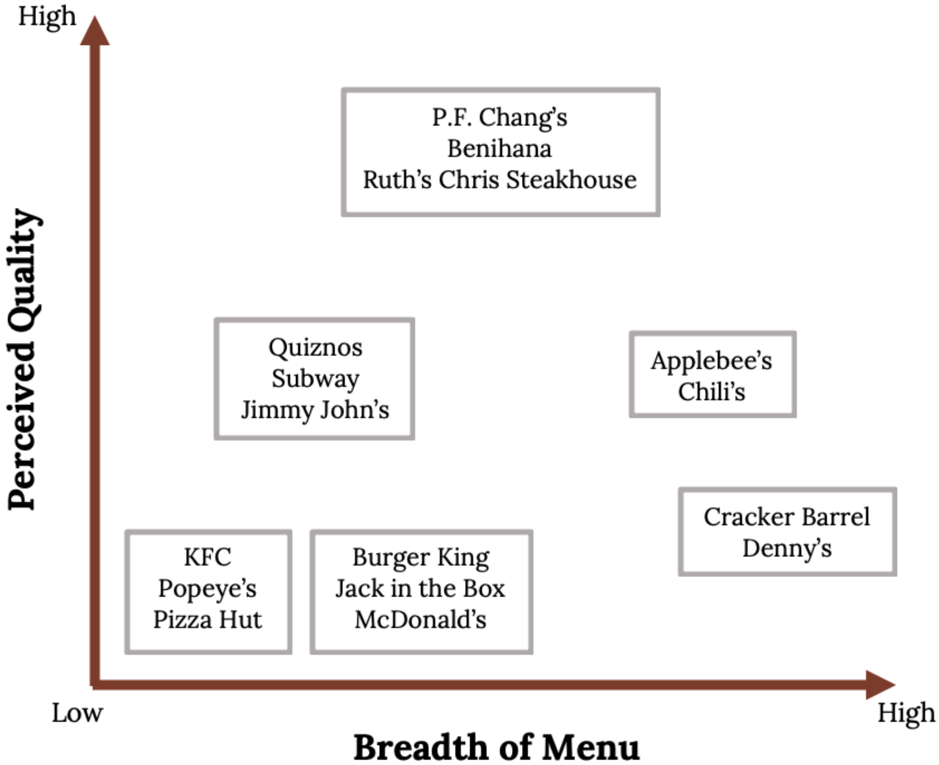


*Figure 3.15: Strategic groups are sets of firms that follow similar strategies. Understanding the nature of strategic groups within an industry is important in part because the members of a firm's group are usually that firm's closest rivals. Below we illustrate several strategic groups in the restaurant industry.*

Third, the analysis of strategic groups can reveal gaps in the industry that represent untapped opportunities. Within the restaurant business, for example, it appears that no national chain offers both very high quality meals and a very diverse menu. Perhaps the firm that comes the closest to filling this niche is the Cheesecake Factory, a chain of approximately 150 outlets whose menu includes more than 200 lunch, dinner, and dessert items. Ruth's Chris Steak House already offers very high quality food; its executives could consider moving the firm toward offering a very diverse menu as well. This would involve considerable risk, however. Perhaps no national chain offers both very high quality meals and a very diverse menu because doing so is extremely difficult. Nevertheless, examining the strategic groups in an industry with an eye toward untapped opportunities offers executives a chance to consider novel ideas.

*Figure 3.16: Mid-quality restaurants do not compete directly with pricey steakhouses, but they might be able to borrow ideas from such venues.*

## Designing a Strategic Group Map

To develop a strategic group map for an industry, the competitive factors for each of the two axes must be selected. On the vertical axis, price is often the measurement used. A different parameter that further differentiates the members of the industry is chosen for the horizontal axis. For the airline industry, for example, it could be the number of routes flown. It can be the breadth of models offered by each car manufacturer in the automobile industry. The competitive factors should be chosen based on the market characteristics that are to be examined, usually the most important ones.

Once the various firms in the industry are plotted on the strategic group map, the natural groupings of the companies can be determined and circled. The stiffest competition in the industry typically happens within each strategic group. Profitability between each group often varies. It is generally difficult to move from one group to another, as mobility barriers exist hindering the ability of a firm to impact the chosen competitive factors being measured.

### Section Video

*Strategic Group Mapping* [05:42]

The video for this lesson gives further insights and an example of constructing a strategic group map.

You can view this video here: https://youtu.be/CcF3ZMgXQrA.

### *Key Takeaway*

- Examination of the strategic groups in an industry provides a firm's executives with a better understanding of their closest rivals, reveals alternative paths to success, and highlights untapped opportunities.

### *Exercises*

1. What other colleges and universities are probably in your school's strategic group?
2. From what other groups of colleges and universities could your school learn? What specific ideas could be borrowed from these groups?

## References


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## Image Credits

Figure 3.15: Kindred Grey (2020). "Breadth of menu vs. Quality" CC BY-SA 4.0. Retrieved from https://commons.wikimedia.org/wiki/File:Breadth_of_menu_vs._Quality.png.

Figure 3.16: With wind. "Steak." CC BY-NC 2.0. Cropped. Retrieved from https://flic.kr/p/brpy2C.

## Video Credits

ddd9255. (2013, September 1). *Strategic group mapping* [Video]. YouTube. https://youtu.be/CcF3ZMgXQrA.

# 3.6 Conclusion

This chapter explains several considerations for examining the external environment that executives must monitor to lead their organizations strategically. Executives must be aware of trends and changes in the general environment, as well as the condition of their specific industry, as elements of both have the potential to change considerably over time. While PESTEL analysis provides a useful framework to understand the general environment, Porter's five forces is helpful to make sense of an industry's profit potential and competitive environment. Strategic groups are valuable for understanding close competitors that affect a firm more than other industry members. When executives carefully monitor their organization's environment using these tools, they greatly increase the chances of their organization being successful.

*Exercises*

1. In groups of four or five, use the PESTEL framework to identify elements from each factor of the general environment that could have a large effect on your future career.
2. Use Porter's five forces analysis to analyze an industry in which you might like to work in the future. Discuss the implications your results may have on the salary potential of jobs in that industry and how that could impact your career plans.