**Module 2 - Background**

**THE EXTERNAL ENVIRONMENT, INTERNAL PROFILE, AND SWOT**

**Part 1: External Environment Analysis**

SWOT is an acronym for: *Strengths, Weaknesses, Opportunities*, and *Threats*. The first two variables (strengths and weaknesses) relate to the *internal organization*, while the last two variables (opportunities and threats) relate to the organization’s *external environment*.

The purpose of an external analysis is to scan the outside environment for factors that might open up new opportunities for the business—or that may present threats to the survival of the organization. Then company managers and executives can formulate plans to take advantage of the opportunities and respond to external threats. Optimally, the organization wishes to altogether eliminate (and if this is not possible, to ameliorate to the greatest extent possible) those threats that exist in the external environment.

There are endless numbers and kinds of external factors that can have an effect on a company’s sustainability. Customers, competitors, and suppliers are all pretty obvious entities that can affect profitability. If we think a little more deeply, however, we can see that current as well as potential customers should be considered in an assessment of opportunities and threats (e.g., in terms of changing consumer tastes and preferences). Any such threats or opportunities will affect strategic choices that will (or that*can*) be made concerning products and services.

What about technology? Advances in technology can affect all three of our "obvious" external concerns (customers, competitors, and suppliers) with changes in product features, how products are made and sold, what services are offered and how they are delivered, supply chains, inventory controls, and so on. The failure to monitor the technological environment can spell obsolescence for a business in no time.

Ease of substitution is something we always think of when considering competitors. How easy would it be to switch from flying on one airline to flying on another, for example? But thinking more creatively about substitution, we can see that teleconferencing and video conferencing can eliminate the need for much business travel—thus acting as a *substitute* to airline tickets. Failure to think broadly enough will cause a planner to completely miss a major threat just over the horizon. For example, consider the immeasurable impact that Internet sites such as eBay and Amazon have had on the sales of "brick-and-mortar" operations. Or consider how online video availability has adversely affected companies that sell or rent DVDs, such as Blockbuster.

The sheer number of possible external influences creating opportunities and threats is mind-boggling. This is why most strategic planners use analytic models to structure their thinking and help avoid perceptual biases that might interfere with a clear and objective identification of opportunities and threats.

In this course, we will be using two different models that approach the external environment from two different perspectives:

1. Industry environment - Porter's Five Forces Model
2. Macro environment - PEST analysis

**Industry Environment**

Porter's Model of Five Forces is one of the most versatile frameworks for analyzing the industry (or operating) external environment. Employed by a variety of academics and business practitioners for more than three decades, the Five Forces Model has proved its usefulness in a variety of arenas. The Porter model helps the user get a handle on the competitive and market characteristics of a specific industry. The factors covered by the Five Forces Model are:

1. Threat of new entrants
2. Bargaining power of suppliers
3. Bargaining power of customers
4. Availability of substitutes
5. Degree of rivalry among competitors

**Macro Environment**

While the Porter analysis looks at the conditions in a specific industry, the PEST analysis looks at factors that affect the greater business environment. The sub-environments addressed by this model include:

1. Political (including regulatory)
2. Economic
3. Socio-cultural
4. Technical

**Required Reading**

For a general introduction to the Five Forces Model, the following video interview with Michael Porter is helpful for putting the external analysis into perspective:

The five competitive forces that shape strategy. (2008). *Harvard Business Publishing.* Podcast retrieved on August 28, 2014, from [*http://www.youtube.com/watch?v=mYF2\_FBCvXw*](https://www.youtube.com/watch?v=mYF2_FBCvXw)

The following site is an excellent introduction to the industry (operating) and remote (macro) environments. This site is a very good overview of Porter's Five Forces and PEST: [*http://web.missouri.edu/cookml/AE4972/Industry%20Analysis.pdf*](http://web.missouri.edu/cookml/AE4972/Industry%20Analysis.pdf)

Connelley, D. (2005). [*Strategy for the External Environment*](https://tlc.trident.edu/content/enforced/118058-X_FUTURE_MGT599-MOD/Strategy%20for%20the%20external%20environment.ppt?_&d2lSessionVal=VDUCMMeB44MUXRe7NBAYFPDIF&ou=118058&_&d2lSessionVal=NAFbRsHLw6deK7IMO7Ha3c1YO&ou=156827). Power Point Presentation.

PEST analysis. (2009). Retrieved on August 28, 2014, from [*http://www.valuebasedmanagement.net/methods\_PEST\_analysis.html*](http://www.valuebasedmanagement.net/methods_PEST_analysis.html)

Porter's Five Forces: A model for industry analysis. (2007). Retrieved on August 28, 2014, from [*http://www.quickmba.com/strategy/porter.shtml*](http://www.quickmba.com/strategy/porter.shtml)

SWOT analysis: Lesson. (2009). *Marketing Teacher.* Retrieved from [*http://www.marketingteacher.com/swot-analysis-marketing-tools-from-marketing-teacher/*](http://www.marketingteacher.com/swot-analysis-marketing-tools-from-marketing-teacher/)

**Optional Material**

Carrying out a PEST analysis. (2005). *The Free Library.* Retrieved on August 28, 2014, from [*http://www.thefreelibrary.com/Carrying+out+a+PEST+analysis-a0141751272*](http://www.thefreelibrary.com/Carrying+out+a+PEST+analysis-a0141751272)

PEST analysis. (2007). *Quick MBA*. Retrieved on August 28, 2014, from [*http://www.quickmba.com/strategy/pest/*](http://www.quickmba.com/strategy/pest/)

Porter’s Five Forces. (2009). *Mind Tools.* Retrieved on August 28, 2014, from [*http://www.mindtools.com/pages/article/newTMC\_08.htm*](http://www.mindtools.com/pages/article/newTMC_08.htm)

Porter’s Five Forces (2007). *The Manager.* Retrieved on August 28, 2014, from [*http://www.themanager.org/Models/p5f.htm*](http://www.themanager.org/Models/p5f.htm)

Zahorsky, D. (2009). A business owner's secret weapon: SWOT analysis. Retrieved on August 28, 2014, from [*http://sbinformation.about.com/cs/bestpractices/a/swot.htm*](http://sbinformation.about.com/cs/bestpractices/a/swot.htm)

**Part 2: Internal Analysis**

One of the criticisms of Porter's Five Forces Model (and external analyses in general) is that while Five Forces can certainly help in the identification of problems and difficulties that firms are likely to encounter in a given industry, the model does not provide insight into what a particular company can do to *manipulate* those forces in its favor, thus gaining a competitive advantage.

In Part 2 of this module, we will focus on an analysis of the internal environment, or the internal company. At the conclusion of this process, we will have what is sometimes referred to as a "company profile" or an "internal profile." Two useful frameworks that will help us to focus on the essential factors for analysis of the internal environment are Porter's Value Chain and the Resource Based View framework (RBV).

After conducting an analysis of an organization’s internal environment, you will be in a position to complete the last two elements of the SWOT analysis: identification of the strengths and weaknesses of a company.

**Internal Analysis Components**

Before we introduce the analytical models we will be using in this module, some background information will be helpful. A company has (A) primary activities and (B) support activities.

A company’s primary activities are:

* Research and Development (R&D)
* Production (manufacturing)
* Marketing and Sales
* Customer Service

A company’s support activities include:

* Materials Management
* Human Resources
* Information Systems
* Infrastructure

**A. Primary Activities**

* *Research and Development* (R&D) includes development and design of products and production processes. Many manufacturing companies have separate R&D departments. For highly innovative companies (such as 3M), this may be one of the most important departments in the organization. Some service companies may include R&D activities as a part of marketing or customer service functions. For instance, banks introduce new products to attract customers.
* *Production*is in charge of creating goods or services. Some companies manufacture products. Banks make loans. Retail companies sell products. These are instances of production.
* *Marketing and Sales* plays several roles. It advertises and positions the brand, identifies marketing needs, and sets pricing.
* *Customer Service* provides after-sale service.

**B. Support Activities**

* *Materials Management* manages the logistics of moving materials from procurement of inputs to production and then moving outputs through distribution to customers. Inventory management is part of the Materials Management support activity.
* *Human Resources* is focused on employing the necessary skills mix to carry out the organization's mission, and to motivate, train, and compensate the workforce.
* *Information Systems* refers to computer support in processing functions and supporting company operations, as well as Internet.
* *Infrastructure*refers to organizational structure, controls, and culture. The infrastructure must be capable of supporting the primary activities of the organization and must also be compatible with its strategy.

**Presentation on the Internal Environment**

Review the following presentation by Dr. Connelley. For Part Two of the narrated slide presentation on strategic situation analysis, click on the title below. This slide presentation focuses on the importance of optimizing the internal functions of an organization to create added value to the firm's products or services: [*Strategy for the Internal Environment*](https://tlc.trident.edu/content/enforced/118058-X_FUTURE_MGT599-MOD/Strategy%20for%20the%20Internal%20Environment.ppt?_&d2lSessionVal=VDUCMMeB44MUXRe7NBAYFPDIF&ou=118058&_&d2lSessionVal=NAFbRsHLw6deK7IMO7Ha3c1YO&ou=156827)

**Porter's Value Chain**

Porter's Value Chain is a widely used framework for organizing and interpreting an internal analysis. It is pictured below and is also discussed in the previous PowerPoint presentation. You can see that the Value Chain considers both primary and support activities, although it may use slightly different labels and definitions. By managing the various components of the value chain, companies can achieve a cost advantage over competitors, or distinguish themselves from competitors by offering a distinctively better product or service. Read more about Value Chain analysis at:

The value chain. (2007). Retrieved on August 28, 2014, from [*http://www.netmba.com/strategy/value-chain/*](http://www.netmba.com/strategy/value-chain/)

While the Value Chain can be a valuable tool for breaking down and streamlining costs and creating maximum value, it is a complicated process that typically involves considerable quantitative analysis.

**The Resource-Based View**

The Resource-Based View (RBV) arose in direct response to the criticism mentioned previously, that is, the external analysis is much less useful to a company seeking to attain a competitive advantage than are its internal capabilities and resources.

Instead of focusing on the accumulation of resources necessary to implement the strategy dictated by conditions and constraints in the external environment (I/O model), the resource-based view suggests that a firm's unique resources and capabilities provide the basis for a strategy. The business strategy chosen should allow the firm to best exploit its core competencies relative to opportunities in the external environment (p. 1380).\*\*\*

\*\*\* Source: Hitt, M., Ireland, R., and Hoskisson, R. (2007). A resource-based view of the firm. In *International Encyclopedia of Organization Studies* (Clegg, S., & Bailey, J.R., Eds.). Thousand Oaks, CA: Sage Publications.

Central to this analytical view is the notion that a firm's core competencies and resources are *more* critical to the development of a strategy than the external environment. In reality, the truth probably lies somewhere in between, with a balance between external demands and internal capacities leading to the most successful competitive position. This is the essence of a SWOT analysis, and RBV can certainly inform an analysis of strengths and weaknesses.

For an excellent review of the basics of the Resource-Based View, read the following chapter:

Henry, A. (2007). The internal environment: A resource based view of strategy. In *Understanding Strategic Management*. Oxford University Press. Retrieved on August 27, 2014, from [*http://fba.aiub.edu/Files/Uploads/MGT110043.pdf*](http://fba.aiub.edu/Files/Uploads/MGT110043.pdf)

**Required**

Connelley, D. [*Strategy for the internal environment.*](https://tlc.trident.edu/content/enforced/118058-X_FUTURE_MGT599-MOD/Strategy%20for%20the%20Internal%20Environment.ppt?_&d2lSessionVal=VDUCMMeB44MUXRe7NBAYFPDIF&ou=118058&_&d2lSessionVal=NAFbRsHLw6deK7IMO7Ha3c1YO&ou=156827) PowerPoint presentation.

Henry, A. (2007). The internal environment: A resource based view of strategy. In *Understanding Strategic Management*. Oxford University Press. Retrieved on August 27, 2014, from [*http://fba.aiub.edu/Files/Uploads/MGT110043.pdf*](http://fba.aiub.edu/Files/Uploads/MGT110043.pdf)

The following presentation is a good overview of internal analysis:

Bramha, D. (2011). Internal Analysis in Strategic Management. Retrieved on November 6, 2012, from [*http://www.slideshare.net/guestd507e7/internal-analysys-of-strategic-management-presentation*](http://www.slideshare.net/guestd507e7/internal-analysys-of-strategic-management-presentation)