2

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

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

2-1 Explain the importance of analyzing and understanding the firm's external environment.

2-2 Define and describe the general environment and the industry environment.

2-3 Discuss the four parts of the external environmental analysis process.

2-4 Name and describe the general environment's seven segments.

2-5 Identify the five competitive forces and explain how they determine an industry's profitability potential.

2-6 Define strategic groups and describe their influence on firms.

2-7 Describe what firms need to know about their competitors and different methods (including ethical standards) used to collect intelligence about them.

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CRACKS IN THE GOLDEN ARCHES AND MCDONALD'S NEW GLUE

McDonald's is the largest restaurant chain in the world. It has 14,155 restaurants in the United States, and 36,899 restaurants worldwide—in more than 100 countries. It employs 1.5 million people and serves approximately 69 million customers daily. It sells 9 million pounds of french fries daily and sells 550 million Big Macs annually. Over the years, McDonald's was a leader, not only in market share, but also with the introduction of new menu items to the fast food market. For example, it first introduced breakfast items to this market, and its breakfast menu now accounts for about 25 percent of its sales. It successfully introduced Chicken McNuggets to this market, and also successfully introduced gourmet coffee products and began to compete against Starbucks. With all this success, what is the problem?

The problems revolve around competition and changing consumer tastes. Consumers have become more health-conscious, and competitors have been more attuned to customer desires. As a result, McDonald's suffered a decline in its total sales revenue of 18.9 percent from its high point in 2013 of $28.1 billion to $22.8 billion in 2017. It seems that McDonald's did a poor job of analyzing its environment and especially its customers and competitors. During this same time, some of McDonald's competitors flourished. For example, Sonic and Chipotle recorded significant increases in their annual sales. Other specialty burger restaurants, such as Smashburger, have stolen business from McDonald's even though their burgers are priced higher. The quality of these competitors' products is perceived to be higher, and many are "made to order" and thus customized to the customer's desires. And, partly because the volume and complexity of the McDonald's menu items have grown, the time required to provide service has also increased.

Ruaridh Stewart/ZUMA Press/Newscom

Healthier choice options now available at McDonald's to satisfy the more health-conscious consumer.

Failing to understand the changing market and competitive landscape, McDonald's was unable to be proactive and thus tried to be reactive but without much success. Because of these problems, McDonald's hired a new CEO in 2015, hoping to overcome its woes. With a thorough analysis of its customers and competition and its products and services, McDonald's developed a strategy to achieve a multi-year turnaround. It is adding new products to its menu and has enhanced the healthiness of those products along with enhancing their quality. For example, McDonald's announced that it will now use only chickens raised without antibiotics to be sensitive to human health concerns. Changing vegetables in Happy Meals (e.g., adding baby carrots) and implementing new wraps that require additional (new) vegetables (such as cucumbers) are meant to enhance the healthiness of the McDonald's menu. It has also introduced signature sandwiches, Quarter Pounders cooked with fresh meat only (not frozen), new espresso-based drinks, and other quality items.

Other parts of its multi-year strategy include renovated restaurants, digital ordering, and new delivery services. McDonald's was once a leader, and now it is fighting regain its position, trying to stem the downturn. It is now responding to its external environment, especially its customers and competitors. Sales began to pick up in the last part of 2017. Within the next few years, we will know whether these changes succeed.

Sources: C. Smith, 2018, 40 Interesting McDonald's facts and statistics, *DMR Business Statistics*, https://expanded ramblings .com/index.php/mcdonalds-statistics/, February 19; J. Wohl, 2018, McDonald's makes happy meals (slightly) healthier, *AdAge*, http://adage.com, February 15; J. Wohl, 2018, McDonald's CMO bullish on tiered value menu amid competition, *AdAge*, http://adage.com, January 5; K. Taylor, 2017, McDonald's makes 6 major changes that totally turned business around, *Business Insider*, www.businessinsider.com, October 24; S. Whitten, 2017, 4 ways McDonald's is about to change, CNBC, www.cnbc.com; A. Gasparro, 2015, McDonald's new chief plots counter attack, *Wall Street Journal*, www.wsj.com, March 1; D. Shanker, 2015, Dear McDonald's new CEO: Happy first day. Here's some (unsolicited) advice, *Fortune*, www.Fortune.com, March 2; S. Strom, 2015, McDonald's seeks its fast-food soul, *New York Times*, www.nytimes.com, March 7; S. Strom, 2015, McDonald's tests custom burgers and other new concepts as sales drop, *New York Times*, www.nytimes.com, January 23; B. Kowitt, 2014, Fallen Arches, *Fortune*, December, 106–116.

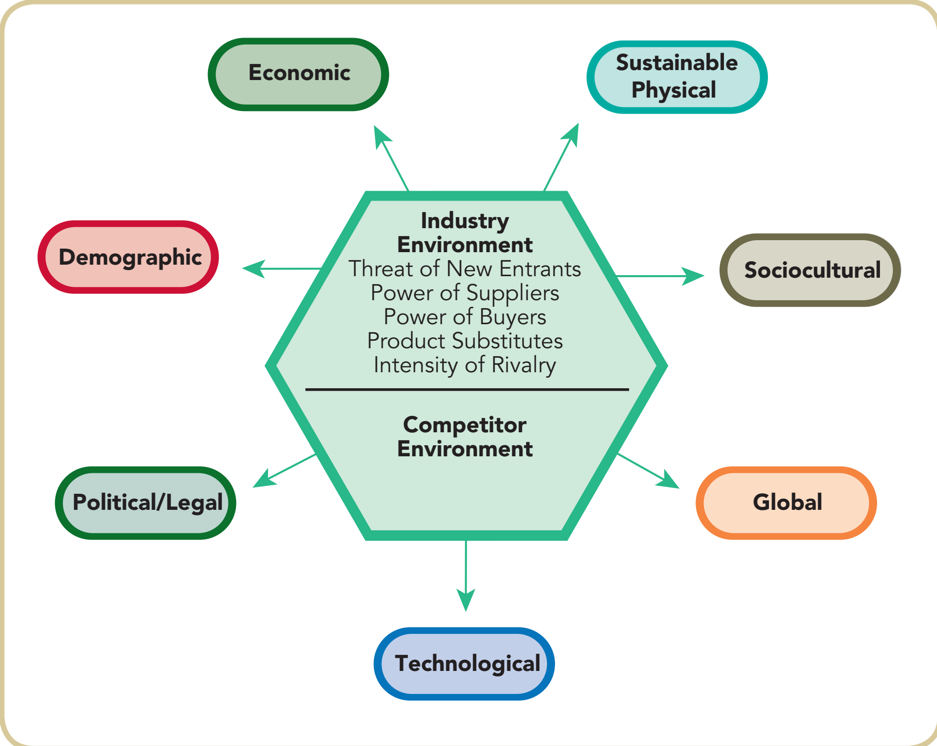
As suggested in the Opening Case and by research, the external environment (which includes the industry in which a firm competes as well as those against whom it competes) affects the competitive actions and responses firms take to outperform competitors and earn above-average returns.[1] For example, McDonald's has been experiencing a reduction in returns in recent times because of changing consumer tastes and enhanced competition. McDonald's is attempting to respond to the threats from its environment by changing its menu, revising the types of supplies it purchases, remodeling its restaurants, and implementing digital sales and home delivery of food orders. The sociocultural segment of the general environment (discussed in this chapter) is the driver of some of the changing values in society that are now placing greater emphasis on healthy food choices. As the Opening Case describes, McDonald's is responding to these changing values by, for example, using only antibiotic-free chicken and making its Happy Meals healthier.

As noted in Chapter 1, the characteristics of today's external environment differ from historical conditions. For example, technological changes and the continuing growth of information gathering and processing capabilities increase the need for firms to develop effective competitive actions and responses on a timely basis.[2] (We fully discuss competitive actions and responses in Chapter 5.) Additionally, the rapid sociological changes occurring in many countries affect labor practices and the nature of products that increasingly diverse consumers demand. Governmental policies and laws also affect where and how firms choose to compete.[3] And, changes to several nations' financial regulatory systems were enacted after the financial crisis in 2008–2009 that increased the complexity of organizations' financial transactions.[4] (However, in 2018 the Trump administration weakened or eliminated some of those regulations in the United States.)

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

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

Figure 2.1 The External Environment



2-1 The General, Industry, and Competitor Environments

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

Firms cannot directly control the general environment's segments. Accordingly, what a company seeks to do is recognize trends in each segment of the general environment and then *predict* each trend's effect on it. For example, it has been predicted that over the next 10 to 20 years, millions of people living in emerging market countries will join the middle class. In fact, by 2030, it is predicted that two-thirds of the global middle class, about 525 million people, will live in the Asia-Pacific region of the world.[8] Of course, this is not surprising given that almost 60 percent of the world's population is located in Asia.[9] No firm, including large multinationals, is able to control where growth in potential customers may take place in the next decade or two. Nonetheless, firms must study this anticipated trend as a foundation for predicting its effects on their ability to identify strategies to use that will allow them to remain successful as market conditions change.

The **industry environment** is the set of factors that directly influences a firm and its competitive actions and responses: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes, and the intensity of rivalry

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Table 2.1 The General Environment: Segments and Elements

Demographic segment	• Population size • Age structure • Geographic distribution	• Ethnic mix • Income distribution
Economic segment	• Inflation rates • Interest rates • Trade deficits or surpluses • Budget deficits or surpluses	• Personal savings rate • Business savings rates • Gross domestic product
Political/Legal segment	• Antitrust laws • Taxation laws • Deregulation philosophies	• Labor training laws • Educational philosophies and policies
Sociocultural segment	• Women in the workforce • Workforce diversity • Attitudes about the quality of work life	• Shifts in work and career preferences • Shifts in preferences regarding product and service characteristics
Technological segment	• Product innovations • Applications of knowledge	• Focus of private and government-supported R&D expenditures • New communication technologies
Global segment	• Important political events • Critical global markets	• Newly industrialized countries • Different cultural and institutional attributes
Sustainable physical environment segment	• Energy consumption • Practices used to develop energy sources • Renewable energy efforts • Minimizing a firm's environmental footprint	• Availability of water as a resource • Producing environmentally friendly products • Reacting to natural or man-made disasters

among competing firms.[10] In total, the interactions among these five factors determine an industry's profitability potential; in turn, the industry's profitability potential influences the choices each firm makes about its competitive actions and responses. The challenge for a firm is to locate a position within an industry where it can favorably influence the five factors or where it can successfully defend itself against their influence. The greater a firm's capacity to favorably influence its industry environment, the greater the likelihood it will earn above-average returns.

How companies gather and interpret information about their competitors is called **competitor analysis**. Understanding the firm's competitor environment complements the insights provided by studying the general and industry environments.[11] This means, for example, that McDonald's needs to do a better job of analyzing and understanding its general and industry environments.

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

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2-2 External Environmental Analysis

Most firms face external environments that are turbulent, complex, and global—conditions that make interpreting those environments difficult.[12] To cope with often ambiguous and incomplete environmental data and to increase understanding of the general environment, firms complete an *external environmental analysis*. This analysis has four parts: scanning, monitoring, forecasting, and assessing (see Table 2.2).

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

In terms of possible opportunities, a combination of cultural, political, and economic factors is resulting in rapid retail growth in parts of Africa, Asia, and Latin America. Accordingly, Walmart, the world's largest retailer, and the next three largest global giants (France's Carrefour, UK–based Tesco, and Germany's Metro) are expanding in these regions. Walmart is expanding its number of retail units in Chile (404 units), India (20 units), and South Africa (360 units). Interestingly, Carrefour exited India after four years and in the same year that Tesco opened stores in India. While Metro closed its operations in Egypt, it has stores in China, Russia, Japan, Vietnam, and India in addition to many eastern European countries.[13]

A **threat** is a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness.[14] Intellectual property protection has become a significant issue not only within a country but also across country borders. For example, in 2018 President Trump placed tariffs on goods exported from China into the United States. The primary reason given for the tariffs was the theft of U.S. firms' intellectual property by Chinese firms. As is common in these cases, China responded by placing tariffs on a large number of U.S. products exported to China, sparking fears of a potential trade war between the two countries with the largest economies in the world. This type of threat obviously deals with the political/legal segment.

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

2-2a Scanning

Scanning entails the study of all segments in the general environment. Although challenging, scanning is critically important to the firms' efforts to understand trends in the

Table 2.2 Parts of the External Environment Analysis

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

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general environment and to predict their implications. This is particularly the case for companies competing in highly volatile environments.[15]

Through scanning, firms identify early signals of potential changes in the general environment and detect changes that are already under way.[16] Scanning activities must be aligned with the organizational context; a scanning system designed for a volatile environment is inappropriate for a firm in a stable environment.[17] Scanning often reveals ambiguous, incomplete, or unconnected data and information that require careful analysis.

Many firms use special software to help them identify events that are taking place in the environment and that are announced in public sources. For example, news event detection uses information-based systems to categorize text and reduce the trade-off between an important missed event and false alarm rates. Increasingly, these systems are used to study social media outlets as sources of information.[18]

Broadly speaking, the Internet provides a wealth of opportunities for scanning. Amazon.com, for example, records information about individuals visiting its website, particularly if a purchase is made. Amazon then welcomes these customers by name when they visit the website again. The firm sends messages to customers about specials and new products similar to those they purchased in previous visits. A number of other companies, such as Netflix, also collect demographic data about their customers in an attempt to identify their unique preferences (demographics is one of the segments in the general environment). Approximately 4 billion people use the Internet in some way, including more than 738 million in China and 287 million in the United States. So, the Internet represents a healthy opportunity to gather information on users.[19]

2-2b Monitoring

When *monitoring*, analysts observe environmental changes to see if an important trend is emerging from among those spotted through scanning.[20] Critical to successful monitoring is the firm's ability to detect meaning in environmental events and trends. For example, those monitoring retirement trends in the United States learned that the median retirement savings of U.S. workers was only $5000. And for those who are aged 56-61, the median savings for retirement was only $17,000. For a reasonable retirement, Fidelity estimates that people should have saved 10 times their annual salary.[21] Firms seeking to serve retirees' financial needs will continue monitoring workers' savings and investment patterns to see if a trend is developing. If, say, they identify that saving less for retirement (or other needs) is indeed a trend, these firms will seek to understand its competitive implications.

Effective monitoring requires the firm to identify important stakeholders and understand its reputation among these stakeholders as the foundation for serving their unique needs.[22] (Stakeholders' unique needs are described in Chapter 1.) One means of monitoring major stakeholders is by using directors that serve on other boards of directors (referred to as interlocking directorates). They facilitate information and knowledge transfer from external sources.[23] Scanning and monitoring are particularly important when a firm competes in an industry with high technological uncertainty.[24] Scanning and monitoring can provide the firm with information. These activities also serve as a means of importing knowledge about markets and about how to successfully commercialize the new technologies the firm has developed.[25]

2-2c Forecasting

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

Forecasting events and outcomes accurately is challenging. Forecasting demand for new technological products is difficult because technology trends are continually shortening product life cycles. This is particularly difficult for a firm such as Intel, whose products go into many customers' technological products, which are frequently updated. Thus, having access to tools that allow better forecasting of electronic product demand is of value to Intel as the firm studies conditions in its external environment.[27]

2-2d Assessing

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

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

2-3 Segments of the General Environment

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

2-3a The Demographic Segment

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

Population Size

The world's population doubled (from 3 billion to 6 billion) between 1959 and 1999. Current projections suggest that population growth will continue in the twenty-first century, but at a slower pace. In 2018, the world's population was 7.6 billion, and it is projected to be 9.2 billion by 2040 and roughly 10 billion by 2055.[31] In 2018, China was the world's largest country by population with slightly more than 1.4 billion people. By

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2050, however, India is expected to be the most populous nation in the world followed by China, the United States, Indonesia, and Pakistan.[32] Firms seeking to find growing markets in which to sell their goods and services want to recognize the market potential that may exist for them in these five nations.

Firms also want to study changes occurring within the populations of different nations and regions of the world to assess their strategic implications. For example, 28 percent of Japan's citizens are 65 or older, while the figures for the United States and China are 15 percent and 11 percent, respectively. However, the population in both countries is aging rapidly and could match that in Japan by 2040.[33] Aging populations are a significant problem for countries because of the need for workers and the burden of supporting retirement programs. In Japan and some other countries, employees are urged to work longer to overcome these problems.

Age Structure

The most noteworthy aspect of this element of the demographic segment is that the world's population is rapidly aging, as noted above. For example, predictions are that the number of centenarians worldwide will double by 2023 and double again by 2035. Projections suggest life expectancy will surpass 100 in some industrialized countries by the second half of this century—roughly triple the lifespan of the population in earlier years.[34] In the 1950s, Japan's population was one of the youngest in the world. However, 45 is now the median age in Japan, with the projection that it will be 55 by 2040. With a fertility rate that is below replacement value, another prediction is that by 2040 there will be almost as many Japanese people 100 years old or older as there are newborns.[35] By 2050, almost 25 percent of the world's population will be aged 65 or older. These changes in the age of the population have significant implications for availability of qualified labor, health care, retirement policies, and business opportunities among others.[36]

This aging of the population threatens the ability of firms to hire and retain a workforce that meets their needs. Thus, firms are challenged to increase the productivity of their workers and/or to establish additional operations in other nations in order to access the potential working age population. A potential opportunity is represented by delayed retirements; older workers with extended life expectancies may need to work longer in order to eventually afford retirement. Delayed retirements may help companies to retain experienced and knowledgeable workers. In this sense, "organizations now have a fresh opportunity to address the talent gap created by a shortage of critical skills in the marketplace as well as the experience gap created by multiple waves of downsizing over the past decade."[37] Firms can also use their older, more experienced workers to transfer their knowledge to younger employees, helping them to quickly gain valuable skills. There is also an opportunity for firms to more effectively use the talent available in the workforce. For example, moving women into higher level professional and managerial jobs could offset the challenges created by decline in overall talent availability. And, based on research, it may even enhance overall outcomes.[38]

Geographic Distribution

How a population is distributed within countries and regions is subject to change over time. For example, over the last few decades, the U.S. population has shifted from states in the Northeast and Great Lakes region to states in the West (California), South (Florida), and Southwest (Texas). Based on data in 2018, California's population has grown by approximately 2.3 million since 2010, while Texas's population has grown by 3.2 million in the same time period.[39] These changes are characterized as moving from the "Frost

Belt" to the "Sun Belt." Outcomes from these shifts include the fact that the gross domestic product (GDP) of California in 2017 was slightly more than $2.75 trillion, an amount that makes California the sixth-largest economy in the world. In this same year, at a value of $1.6 trillion, Texas' GDP was second to that of California.[40]

The least popular states are Illinois, Vermont, and West Virginia, which experienced population declines between 2010 and 2018. During the same time period, the population of Connecticut, Maine, Michigan, Mississippi, Pennsylvania and Rhode Island grew less than one percent. In the coming years, California, Florida and Texas are forecasted to have the largest gains in population.[41]

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

Of course, geographic distribution patterns differ throughout the world. For example, in past years, the majority of the population in China lived in rural areas; however, growth patterns have been shifting to urban communities such as Shanghai and Beijing. In fact, in 2006, there were 148.7 million more people living in rural areas than in urban areas in China. However, by 2016, 203.2 million more people lived in urban than in rural areas within China, a substantial shift in a only ten-year period.[42] Recent shifts in Europe show small population gains for countries such as France, Germany, and the United Kingdom, while Greece experienced a small population decline. Overall, the geographic distribution patterns in Europe have been reasonably stable.[43]

Ethnic Mix

The ethnic mix of countries' populations continues to change, creating opportunities and threats for many companies as a result. For example, Hispanics have become the largest ethnic minority in the United States.[44] In fact, the U.S. Hispanic market is the third largest "Latin American" economy behind Brazil and Mexico. Spanish is now the dominant language in parts of the United States such as Texas, California, Florida, and New Mexico. Given these facts, some firms might want to assess how their goods or services could be adapted to serve the unique needs of Hispanic consumers. Interestingly, by 2020, more than 50 percent of children in the United States will be a member of a minority ethnic group, and the population in the United States is projected to have a majority of minority ethnic members by 2044. And, by 2060, whites are projected to compose approximately 44 percent of the U.S. population.[45] The ethnic diversity of the population is important not only because of consumer needs but also because of the labor force composition. Interestingly, research has shown that firms with greater ethnic diversity in their managerial team are likely to enjoy higher performance.[46]

Additional evidence is of interest to firms when examining this segment. For example, African countries are the most ethnically diverse in the world, with Uganda having the highest ethnic diversity rating and Liberia having the second highest. In contrast, Japan and the Koreas are the least ethnically diversified in their populations. European countries are largely ethnically homogeneous while the Americas are more diverse. "From the United States through Central America down to Brazil, the 'new world' countries, maybe in part because of their histories of relatively open immigration (and, in some cases, intermingling between natives and new arrivals) tend to be pretty diverse."[47]

Income Distribution

Understanding how income is distributed within and across populations informs firms of different groups' purchasing power and discretionary income. Of particular interest to firms are the average incomes of households and individuals. For instance, the increase in dual-career couples has had a notable effect on average incomes. Although real income has been declining in general in some nations, the household income of dual-career couples has increased, especially in the United States. These figures yield strategically relevant information for firms. For instance, research indicates that whether an employee is part of a dual-career couple can strongly influence the willingness of the employee to accept an international assignment. Worldwide it is estimated that there were almost 57 million expatriates in 2017, with Saudi Arabia, United Arab Emirates, and the United States as the top three destinations.[48]

The growth of the economy in China has drawn many firms, not only for the low-cost production, but also because of the large potential demand for products, given its large population base. However, in recent times, the amount of China's gross domestic product that makes up domestic consumption is the lowest of any major economy at less than one-third. In comparison, India's domestic consumption of consumer goods accounts for two-thirds of its economy, or twice China's level. For this reason, many western multinationals are interested in India as a consumption market as its middle class grows extensively; although India has poor infrastructure, its consumers are in a better position to spend. Because of situations such as this, paying attention to the differences between markets based on income distribution can be very important.[49] These differences across nations suggest it is important for most firms to identify the economic systems that are most likely to produce the most income growth and market opportunities.[50] Thus, the economic segment is a critically important focus of firms' environmental analysis.

2-3b The Economic Segment

The **economic environment** refers to the nature and direction of the economy in which a firm competes or may compete.[51] In general, firms seek to compete in relatively stable economies with strong growth potential. Because nations are interconnected as a result of the global economy, firms must scan, monitor, forecast, and assess the health of their host nation as well as the health of the economies outside it.

It is challenging for firms studying the economic environment to predict economic trends that may occur and their effects on them. There are at least two reasons for this. First, the global recession of 2008 and 2009 created numerous problems for companies throughout the world, including problems of reduced consumer demand, increases in firms' inventory levels, development of additional governmental regulations, and a tightening of access to financial resources. Second, the global recovery from the economic shock in 2008 and 2009 was persistently slow compared to previous recoveries. Firms must adjust to the economic shock and try to recover from it. And although the world economic prospects appear to be good in 2018, the recovery has been uneven across countries. For example, the economies in several European countries continue to struggle (e.g., Greece, Spain). And, perhaps partly due to political uncertainties (e.g., in the United States), there continue to be concerns about economic uncertainty. And again, according to some research, "it is clear that (economic) uncertainty has increased in recent times."[52] This current degree of economic uncertainty makes it challenging to develop effective strategies.

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

When facing economic uncertainty, firms especially want to study closely the economic environment in multiple regions and countries throughout the world. Although economic growth remains relatively weak and economic uncertainty has been strong in Europe, economic growth has been better in the United States in recent times. For example, the projected average annual economic growth in Europe for 2018–2020 is 1.75 percent, while in the United States it is 2.25 percent. Alternatively, the projected average annual economic growth for 2018–2020 is 6.3 percent in China, 7.45 percent in India, 2.25 percent in Brazil, and 2.45 percent in Mexico. These estimates highlight the anticipation of the continuing development of emerging economies.[53] Ideally, firms will be able to pursue higher growth opportunities in regions and nations where they exist while avoiding the threats of slow growth periods in other settings.

AP Images/Brennan Linsley

A marijuana Budtender sorts strands of marijuana for sale at a retail and medical cannabis dispensary in Boulder, Colorado.

2-3c The Political/Legal Segment

The **political/legal segment** is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various local governmental agencies.[54] Essentially, this segment is concerned with how organizations try to influence governments and how they try to understand the influences (current and projected) of those governments on their competitive actions and responses. Commonly, firms develop a political strategy to specify how they will analyze and the political/legal to develop approaches they can take (such as lobbying efforts) to successfully deal with opportunities and threats that surface within this segment of the environment.[55]

Regulations formed in response to new national, regional, state, and/or local laws that are legislated often influence a firm's competitive actions and responses.[56] For example, the state of California in the United States recently legalized the retail selling of cannabis (also known as marijuana). This action follows similar laws legalizing the sale of cannabis in other states such as Colorado and Washington. The immediate concern is the risk that firms take to invest capital in this business, given that it is unknown whether the U.S. Department of Justice will allow the states to proceed without enforcing federal law against the sale of this product. Thus, the relationship between national, regional, and local laws and regulations creates a highly complex environment within which businesses must navigate.[57]

For interactive, technology-based firms such as Facebook, Google, and Amazon, among others, the effort in Europe to adopt the world's strongest data protection law has significant challenges. Highly restrictive laws about consumer privacy could threaten how these firms conduct business in the European Union. Alternatively, firms must deal with quite different challenges when they operate in countries with weak formal institutions (e.g., weak legal protection of intellectual property). Laws and regulations provide structure to guide strategic and competitive actions; without such structure, it is difficult to identify the best strategic actions.[58]

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2-3d The Sociocultural Segment

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

Individual societies' attitudes and cultural orientations are relatively stable, but they can and often do change over time. Thus, firms must carefully scan, monitor, forecast, and assess them to recognize and study associated opportunities and threats. Successful firms must also be aware of changes taking place in the societies and their associated cultural values in which they are competing. Indeed, firms must identify changes in cultural values, norms, and attitudes in order to "adapt to stay ahead of their competitors and stay relevant in the minds of their consumers."[59] Research has shown that sociocultural factors influence the entry into new markets and the development of new firms in a country.[60]

Attitudes about and approaches to health care are being evaluated in nations and regions throughout the world. For Europe, the European Commission has developed a health care strategy for all of Europe that is oriented to preventing diseases while tackling lifestyle factors influencing health such as nutrition, working conditions, and physical activity. This Commission argues that promoting attitudes to take care of one's health is especially important in the context of an aging Europe, as shown by the projection that the proportion of people over 65 living in Europe and in most of the developed nations throughout the world will continue to grow.[61] At issue for business firms is that attitudes and values about health care can affect them; accordingly, they must carefully examine trends regarding health care in order to anticipate the effects on their operations.

The U.S. labor force has evolved to become more diverse, with significantly more women and minorities from a variety of cultures entering the workplace. For example, women were 46.8 percent of the workforce in 2014, a number projected to grow to 47.2 percent by 2024. Hispanics are expected to be about 20 percent of the workforce by 2024. In 2005, the total U.S. workforce was slightly greater than 148 million, and it is predicted to grow to approximately 164 million by 2024.[62]

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

Alexander Raths/Shutterstock.com

Healthcare is becoming increasingly important as the proportion of people older than 65 is growing larger in many nations throughout the world.

However, the rate of growth in the U.S. labor force has declined over the past two decades largely because of slower growth of the nation's population and because of a downward trend in the labor force participation rate. More specifically, data show that the overall participation rate (the proportion of the civilian non-institutional population in the labor force) peaked at an annual average of 67.1 percent in 2000. But the rate has declined since that time and is expected to fall to 58.5 percent by 2050. Other changes in the U.S. labor force between 2010 and 2050 are expected. During this time, Asian membership in the labor force is projected to more than double in size, while the growth in Caucasian members of the labor force is predicted to be much slower compared to other racial groups. In contrast, people of Hispanic origin are expected to account for roughly 80 percent of the total growth in the labor force.[63]

Greater diversity in the workforce creates challenges and opportunities, including combining the best of both men's and women's traditional leadership styles. Although diversity in the workforce has the potential to improve performance, research indicates that diversity initiatives must be successfully managed to reap these organizational benefits.

Although the lifestyle and workforce changes referenced previously reflect the attitudes and values of the U.S. population, each country is unique with respect to these sociocultural indicators. National cultural values affect behavior in organizations and thus also influence organizational outcomes such as differences in managerial styles. Likewise, the national culture influences a large portion of the internationalization strategy that firms pursue relative to one's home country.[64] Knowledge sharing is important for dispersing new knowledge in organizations and increasing the speed in implementing innovations. Personal relationships are especially important in China; the concept of *guanxi* (personal relationships or good connections) is important in doing business within the country and for individuals to advance their careers in what is becoming a more open market society. Understanding the importance of guanxi is critical for foreign firms doing business in China.[65]

2-3e The Technological Segment

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

Given the rapid pace of technological change and risk of disruption, it is vital for firms to thoroughly study the technological segment.[66] The importance of these efforts is shown by the fact that early adopters of new technology often achieve higher market shares and earn higher returns. Thus, both large and small firms should continuously scan the general environment to identify potential substitutes for technologies that are in current use, as well as to identify newly emerging technologies from which their firm could derive competitive advantage.[67]

New technology and innovations are changing many industries.[68] These changes are exemplified by the change to digital publishing (e.g., electronic books) and retail industries moving from brick and mortar stores to Internet sales. As such, firms in all industries must become more innovative in order to survive, and must develop new or at least comparable technology—and continuously improve it.[69] In so doing, most firms must have a sophisticated information system to support their new product development efforts.[70] In fact, because the adoption and efficient use of new technology has become critical to global competitiveness in many or most industries, countries have begun to offer special forms of support, such as the development of technology business incubators, which provide several types of assistance to increase the success rate of new technology ventures.[71]

As a significant technological development, the Internet offers firms a remarkable capability in terms of their efforts to scan, monitor, forecast, and assess conditions in their general environment. Companies continue to study the Internet's capabilities to anticipate how it may allow them to create more value for customers and to anticipate future trends. Additionally, the Internet generates a significant number of opportunities and threats for firms across the world. As noted earlier, there are approximately 4 billion Internet users globally.

Despite the Internet's far-reaching effects and the opportunities and threats associated with its potential, wireless communication technology has become a significant

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

technological opportunity for companies. Handheld devices and other wireless communications equipment are used to access a variety of network-based services. The use of handheld computers (of many types) with wireless network connectivity has become the dominant form of communication and commerce, and additional functionalities and software applications are generating multiple opportunities—and potential threats—for companies of all types.

2-3f The Global Segment

The **global segment** includes relevant new global markets and their critical cultural and institutional characteristics, existing markets that are changing, and important international political events.[72] For example, firms competing in the automobile industry must study the global segment. The fact that consumers in multiple nations are willing to buy cars and trucks "from whatever area of the world"[73] supports this position.

When studying the global segment, firms should recognize that globalization of business markets may create opportunities to enter new markets, as well as threats that new competitors from other economies may also enter their market.[74] In terms of an opportunity for automobile manufacturers, the possibility for these firms to sell their products outside of their home market would seem attractive. But what markets might firms choose to enter? Currently, automobile and truck sales are expected to increase in Brazil, Russia, India, China, and Eastern Europe. In contrast, sales are expected to decline, at least in the near term, in the United States, Western Europe, and Japan. These markets, then, are the most and least attractive ones for automobile manufacturers desiring to sell outside their domestic market. At the same time, from the perspective of a threat, Japan, Germany, Korea, Spain, France, and the United States appear to have excess production capacity in the automobile manufacturing industry. In turn, overcapacity signals the possibility that companies based in markets where this is the case will simultaneously attempt to increase their exports as well as sales in their domestic market.[75] Thus, global automobile manufacturers should carefully examine the global segment to precisely identify all opportunities and threats.

In light of threats associated with participating in international markets, some firms choose to take a more cautious approach to globalization. For example, family business firms, even the larger ones, often take a conservative approach to entering international markets in a manner very similar to how they approach the development and introduction of new technology. They try to manage their risk.[76] These firms participate in what some refer to as *globalfocusing*. Globalfocusing often is used by firms with moderate levels of international operations who increase their internationalization by focusing on global niche markets.[77] This approach allows firms to build onto and use their core competencies while limiting their risks within the niche market. Another way in which firms limit their risks in international markets is to focus their operations and sales in one region of the world.[78] Success with these efforts finds a firm building relationships in and knowledge of its markets. As the firm builds these strengths, rivals find it more difficult to enter its markets and compete successfully.

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

Firms competing in global markets should recognize each market's sociocultural and institutional attributes.[79] For example, Korean ideology emphasizes communitarianism, a characteristic of many Asian countries. Alternatively, the ideology in China calls for an emphasis on *guanxi*—personal connections—while in Japan, the focus is on *wa*—group harmony and social cohesion.[80] The institutional context of China suggests a major emphasis on centralized planning by the government. The Chinese government provides incentives to firms to develop alliances with foreign firms having sophisticated technology, in hopes of building knowledge and introducing new technologies to the Chinese markets over time.[81] As such, it is important to analyze the strategic intent of foreign firms when pursuing alliances and joint ventures abroad, especially where the local partners are receiving technology that may in the long run reduce the foreign firms' advantages.[82]

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

2-3g The Sustainable Physical Environment Segment

The **sustainable physical environment segment** refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to those changes in order to create a sustainable environment.[83] Concerned with trends oriented to sustaining the world's physical environment, firms recognize that ecological, social, and economic systems interactively influence what happens in this particular segment and that they are part of an interconnected global society.[84]

Companies across the globe are concerned about the physical environment, and many record the actions they are taking in reports with names such as "Sustainability" and "Corporate Social Responsibility." Moreover, and in a comprehensive sense, an increasing number of companies are investing in sustainable development.

There are many parts or attributes of the physical environment that firms consider as they try to identify trends in the physical environment.[85] Because of the importance to firms of becoming sustainable, certification programs have been developed to help them understand how to be sustainable organizations.[86] As the world's largest retailer, Walmart's environmental footprint is huge, meaning that trends in the physical environment can significantly affect this firm and how it chooses to operate. Because of this, Walmart's goal is to produce zero waste and to use 100 percent renewable energy to power its operations.[87] Environmental sustainability is important to all societal citizens and because of its importance, customers react more positively to firms taking actions such as those by Walmart.[88] To build and maintain sustainable operations in companies that directly service retail customers requires sustainable supply chain management practices.[89] Thus, top managers must focus on managing any of the firm's practices that have effects on the physical environment. In doing so, they not only contribute to a cleaner environment but also reap financial rewards from being an effective competitor due to positive customer responses.[90]

As our discussion of the general environment shows, identifying anticipated changes and trends among segments and their elements is a key objective of analyzing this environment. With a focus on the future, the analysis of the general environment allows firms to identify opportunities and threats. It is necessary to have a top management team with the experience, knowledge, and sensitivity required to effectively analyze the conditions in a firm's general environment—as well as other facets such as the industry environment and competitors.[91] In fact, as you noted in the Strategic Focus on Target, the lack of a commitment to analyzing the environment in depth can have serious, company-wide ramifications.

The **sustainable physical environment segment** refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to those changes in order to create a sustainable environment.

Strategic **Focus**

Target (Tar-zhey) Is Trying to Navigate in a New and Rapidly Changing Competitive Landscape

Target became known by consumers as Tar-zhey, the retailer of cheaper but 'chic' products. The firm offered a step up in quality goods at a slightly higher price than discount retailers such as Walmart, but was targeted below major, first line retailers such Macy's and Nordstrom. Additionally, it promoted its stores to offer one-stop shopping with clothing, toys, health products, and food goods, among other products. For many years, Tar-zhey "hit the bullseye" and performed well serving this large niche in the market. But the company took its eye off the target and began losing market share (along with other poor strategic actions).

The first major crack in the ship appeared with the announcement of a massive cyberattack on Target's computer system that netted customers' personal information. Not only was this a public relations disaster, it drew a focus on Target that identified other problems. For example, careful analysis showed that Target was losing customers to established competitors and new rivals, especially Internet retailers (e.g., Amazon.com).

Target's marketing chief stated that "it's not that we became insular. We were insular." This suggests that the firm was not analyzing its environment. By allowing rivals, and especially Internet competitors, to woo the company's customers, it lost sales, market share, and profits. It obviously did not predict and prepare for the significant competition from Internet rivals that is now reshaping most all retail industries. Competitors were offering better value to customers (perhaps more variety and convenience through online sales). Thus, Target's reputation and market share were simultaneously harmed.

Because of all the problems experienced, Target hired a new CEO, Brian Cornell, in 2014. Cornell has made a number of changes, but the continued revolution in the industry, largely driven by Amazon, continued to gnaw away Target's annual sales. Target's annual sales declined by approximately 5 percent in 2017 and its stock price suffered as a result. Target was forced to develop a new strategy, which involves a major rebranding. It launched four new brands late in 2017, including A New Day, a fashionable line of women's clothes, and Goodfellow & Co, a modern line of menswear, with the intent to make an emotional connection with customers. It also plans to remodel 100 of its stores and change in-store displays to improve customer experiences. It will add 30 small stores that offer innovative designs and, to compete with Amazon, is emphasizing its digital sales and delivery of products. Up to now its digital strategy has not been highly successful, so it is narrowing its focus to increase its effectiveness.

Glen Stubbe/ZUMA Press/Minneapolis/Minnesota/USA

Goodfellow & Co menswear, a new line introduced by Target in late 2017.

Target plans to discontinue several major brands by 2019 and will continue to introduce new brands (12 in total are planned). The intent is to increase the appeal of Target and its products to millennials. These actions alone suggest the importance of gathering and analyzing data on the market and competitors' actions. The next few years will show the fruits of all of Target's changes. If they are successful, Target will still face substantial competition from Amazon and Walmart; if they are not successful, Target suffer the same fate of of many other large and formerly successful retailers that no exist.

Sources: A. Pasquarelli, 2017, Our strategy is working: Target plows into the holidays, *AdAge*, http://adage.com, October 19; S. Heller, 2017, Target's biggest brands are about to disappear from stores, *The Insider*, www.theinsider.com, July 6; 2017, Rebranding its wheel: Target's new strategy, *Seeking Alpha*, http://seeking alpha.com, July 4;K. Safdar, 2017, Target's new online strategy: Less is more, *Wall Street Journal*, www.wsj.com, May 15; 2015, What your new CEO is reading: Smell ya later; Target's new CEO, *CIO Journal/Wall Street Journal*, www.wsj.com/cio, March 6; J. Reingold, 2014, Can Target's new CEO get the struggling retailer back on target? *Fortune*, www.fortune.com, July 31; G. Smith, 2014, Target turns to PepsiCo's Brian Cornell to restore its fortunes, *Fortune*, www.fortune.com, July 31; P. Ziobro, M. Langley, & J. S. Lublin, 2014, Target's problem: Tar-zhey isn't working. *Wall Street Journal*, www.wsj.com, May 5.

As described in the Strategic Focus, Target failed to maintain a good understanding of its industry and hence, lost market share to Internet company rivals and other more established competitors. We conclude that critical to a firm's choices of strategies and their associated competitive actions and responses is an understanding of its industry environment, its competitors, and the general environment of the countries in which it operates.[92] Next, we discuss the analyses firms complete to gain such an understanding.

2-4 Industry Environment Analysis

An **industry** is a group of firms producing products that are close substitutes. In the course of competition, these firms influence one another. Typically, companies use a rich mix of different competitive strategies to pursue above-average returns when competing in a particular industry. An industry's structural characteristics influence a firm's choice of strategies.[93]

Compared with the general environment, the industry environment (measured primarily in the form of its characteristics) has a more direct effect on the competitive actions and responses a firm takes to succeed.[94] To study an industry, the firm examines five forces that affect the ability of all firms to operate profitably within a given industry. Shown in Figure 2.2, the five forces are: the threats posed by new entrants, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors.

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

Figure 2.2 The Five Forces of Competition Model

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

When studying the industry environment, firms must also recognize that suppliers can become a firm's competitors (by integrating forward) as can buyers (by integrating backward). For example, several firms have integrated forward in the pharmaceutical industry by acquiring distributors or wholesalers. In addition, firms choosing to enter a new market and those producing products that are adequate substitutes for existing products can become a company's competitors.

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

2-4a Threat of New Entrants

Identifying new entrants is important because they can threaten the market share of existing competitors.[95] One reason new entrants pose such a threat is that they bring additional production capacity. Unless the demand for a good or service is increasing, additional capacity holds consumers' costs down, resulting in less revenue and lower returns for competing firms. Often, new entrants have a keen interest in gaining a large market share. As a result, new competitors may force existing firms to be more efficient and to learn how to compete in new dimensions (e.g., using an Internet-based distribution channel).

The likelihood that firms will enter an industry is a function of two factors: barriers to entry and the retaliation expected from current industry participants. Entry barriers make it difficult for new firms to enter an industry and often place them at a competitive disadvantage even when they can enter. As such, high entry barriers tend to increase the returns for existing firms in the industry and may allow some firms to dominate the industry.[96] Thus, firms competing successfully in an industry want to maintain high entry barriers to discourage potential competitors from deciding to enter the industry.

Barriers to Entry

Firms competing in an industry (and especially those earning above-average returns) try to develop entry barriers to thwart potential competitors. In general, more is known about entry barriers (with respect to how they are developed as well as paths firms can pursue to overcome them) in industrialized countries such as those in North America and Western Europe. In contrast, relatively little is known about barriers to entry in the rapidly emerging markets such as those in China.

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

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

Economies of scale can be developed in most business functions, such as marketing, manufacturing, research and development, and purchasing.[97] Firms sometimes form strategic alliances or joint ventures to gain scale economies. And, other firms acquire rivals in order to build economies of scale in the operations and to increase their market share as well.

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

Some competitive conditions reduce the ability of economies of scale to create an entry barrier such as the use of scale free resources.[98] Also, many companies now customize their products for large numbers of small customer groups. In these cases, customized products are not manufactured in the volumes necessary to achieve economies of scale. Customization is made possible by several factors, including flexible manufacturing systems. In fact, the new manufacturing technology facilitated by advanced information systems has allowed the development of mass customization in an increasing number of industries. Online ordering has enhanced customers' ability to buy customized products. Companies manufacturing customized products can respond quickly to customers' needs in lieu of developing scale economies.

Product Differentiation Over time, customers may come to believe that a firm's product is unique. This belief can result from the firm's service to the customer, effective advertising campaigns, or being the first to market a good or service.[99] Greater levels of perceived product uniqueness create customers who consistently purchase a firm's products. To combat the perception of uniqueness, new entrants frequently offer products at lower prices. This decision, however, may result in lower profits or even losses.

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

Capital Requirements Competing in a new industry requires a firm to have resources to invest. In addition to physical facilities, capital is needed for inventories, marketing activities, and other critical business functions. Even when a new industry is attractive, the capital required for successful market entry may not be available to pursue the market opportunity.[100] For example, defense industries are difficult to enter because of the substantial resource investments required to be competitive. In addition, because of the high knowledge requirements of the defense industry, a firm might acquire an existing company as a means of entering this industry, but it must have access to the capital necessary to do this.

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

Occasionally, a decision made by manufacturers to produce a new, innovative product creates high switching costs for customers. Customer loyalty programs, such as airlines' frequent flyer miles, are intended to increase the customer's switching costs. If switching costs are high, a new entrant must offer either a substantially lower price or a much better product to attract buyers. Usually, the more established the relationships between parties, the greater the switching costs.

Access to Distribution Channels Over time, industry participants commonly learn how to effectively distribute their products. After building a relationship with its distributors, a firm will nurture it, thus creating switching costs for the distributors. Access to distribution channels can be a strong entry barrier for new entrants, particularly in consumer nondurable goods industries (e.g., in grocery stores where shelf space is limited) and in international markets.[101] New entrants have to persuade distributors to carry their products, either in addition to or in place of those currently distributed. Price breaks and cooperative advertising allowances may be used for this purpose; however, those practices reduce the new entrant's profit potential. Interestingly, access to distribution is less of a barrier for products that can be sold on the Internet.

Cost Disadvantages Independent of Scale Sometimes, established competitors have cost advantages that new entrants cannot duplicate. Proprietary product technology, favorable access to raw materials, desirable locations, and government subsidies are examples. Successful competition requires new entrants to reduce the strategic relevance of these factors. For example, delivering purchases directly to the buyer can counter the advantage of a desirable location; new food establishments in an undesirable location often follow this practice. Spanish clothing company Zara is owned by Inditex, the largest fashion clothing retailer in the world.[102] From the time of its launching, Zara relied on classy, well-tailored, and relatively inexpensive items that were produced and sold by adhering to ethical practices to successfully enter the highly competitive global clothing market and overcome that market's entry barriers. It is successful because it has used a novel business model in the industry. It also sells quality merchandise for less, offers good stores and store locations, and is well positioned in the industry.[103] Business model innovation may be the key to survival and success in current retail industries.[104]

Government Policy Through their decisions about issues such as the granting of licenses and permits, governments can also control entry into an industry. Liquor retailing, radio and TV broadcasting, banking, and trucking are examples of industries in which government decisions and actions affect entry possibilities. Also, governments often restrict entry into some industries because of the need to provide quality service or the desire to protect jobs. Alternatively, deregulating industries, such as the airline and utilities industries in the United States, generally results in additional firms choosing to enter and compete within an industry.[105] It is not uncommon for governments to attempt to regulate the entry of foreign firms, especially in industries considered critical to the country's economy or important markets within it.[106] Governmental decisions and policies regarding antitrust issues also affect entry barriers. For example, in the United States, the Antitrust Division of the Justice Department or the Federal Trade Commission will sometimes disallow a proposed merger because officials conclude that approving it would create a firm that is too dominant in an industry and would thus create unfair competition. For example, the U.S. Department of Justice filed a suit in 2017 to block the merger of AT&T and Time Warner with the trial initiated in March 2018. The actions of the Department of Justice were unsuccessful and in June 2018, the merger was approved and completed.[107] Such a negative ruling would obviously be an entry barrier for an acquiring firm.

Expected Retaliation

Companies seeking to enter an industry also anticipate the reactions of firms in the industry. An expectation of swift and vigorous competitive responses reduces the likelihood of entry. Vigorous retaliation can be expected when the existing firm has a major stake in the industry (e.g., it has fixed assets with few, if any, alternative uses), when it has substantial resources, and when industry growth is slow or constrained.[108] For example, any firm attempting to enter the airline industry can expect significant retaliation from existing competitors due to overcapacity.

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

DWImages Northern Ireland/Alamy Stock Photo

Honda's entry into the large motorcycle market is changing the competitive landscape especially for the traditional competitors in this market such as Harley-Davidson.

2-4b Bargaining Power of Suppliers

Increasing prices and reducing the quality of their products are potential means suppliers use to exert power over firms competing within an industry. If a firm is unable to recover cost increases by its suppliers through its own pricing structure, its profitability is reduced by its suppliers' actions.[109] A supplier group is powerful when:

- It is dominated by a few large companies and is more concentrated than the industry to which it sells.
- Satisfactory substitute products are not available to industry firms.
- Industry firms are not a significant customer for the supplier group.
- Suppliers' goods are critical to buyers' marketplace success.
- The effectiveness of suppliers' products has created high switching costs for industry firms.
- It poses a credible threat to integrate forward into the buyers' industry. Credibility is enhanced when suppliers have substantial resources and provide a highly differentiated product.[110]

Some buyers attempt to manage or reduce suppliers' power by developing a long-term relationship with them. Although long-term arrangements reduce buyer power, they also increase the suppliers' incentive to be helpful and cooperative in appreciation of the longer-term relationship (guaranteed sales). This is especially true when the partners develop trust in one another.[111]

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

2-4c Bargaining Power of Buyers

Firms seek to maximize the return on their invested capital. Alternatively, buyers (customers of an industry or a firm) want to buy products at the lowest possible price—the point at which the industry earns the lowest acceptable rate of return on its invested capital. To reduce their costs, buyers bargain for higher quality, greater levels of service, and lower prices.[112] These outcomes are achieved by encouraging competitive battles among the industry's firms. Customers (buyer groups) are powerful when:

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

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

2-4d Threat of Substitute Products

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

Newspaper firms have experienced significant circulation declines over the past 20 years. The declines are a result of the ready availability of substitute outlets for news including Internet sources and cable television news channels, along with e-mail and cell phone alerts. Likewise, satellite TV and cable and telecommunication companies provide substitute services for basic media services such as television, Internet, and phone. The many electronic devices that provide services overlapping with the personal computer (e.g., laptops) such as tablets, watches (iWatch), etc. are changing markets for PCs, with multiple niches in the market.

In general, product substitutes present a strong threat to a firm when customers face few if any switching costs and when the substitute product's price is lower or its quality and performance capabilities are equal to or greater than those of the competing product. Interestingly, some firms that produce substitutes have begun forming brand alliances, which research shows can be effective when the two products are of relatively equal quality.

If there is a differential in quality, the firm with the higher quality product will obtain lower returns from such an alliance.[113] Differentiating a product along dimensions that are valuable to customers (such as quality, service after the sale, and location) reduces a substitute's attractiveness.

2-4e Intensity of Rivalry among Competitors

Because an industry's firms are mutually dependent, actions taken by one company usually invite responses. Competitive rivalry intensifies when a firm is challenged by a competitor's actions or when a company recognizes an opportunity to improve its market position.[114]

Firms within industries are rarely homogeneous; they differ in resources and capabilities and seek to differentiate themselves from competitors. Typically, firms seek to differentiate their products from competitors' offerings in ways that customers value and in which the firms have a competitive advantage. Common dimensions on which rivalry is based include price, service after the sale, and innovation. More recently, firms have begun to act quickly (speed a new product to the market) in order to gain a competitive advantage.[115]

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

Numerous or Equally Balanced Competitors

Intense rivalries are common in industries with many companies. With multiple competitors, it is common for a few firms to believe they can act without eliciting a response. However, evidence suggests that other firms generally are aware of competitors' actions, often choosing to respond to them. At the other extreme, industries with only a few firms of equivalent size and power also tend to have strong rivalries. The large and often similar-sized resource bases of these firms permit vigorous actions and responses. The competitive battles between Airbus and Boeing and between Coca-Cola and PepsiCo exemplify intense rivalry between relatively equal competitors.

Slow Industry Growth

When a market is growing, firms try to effectively use resources to serve an expanding customer base. Markets increasing in size reduce the pressure to take customers from competitors. However, rivalry in no-growth or slow-growth markets becomes more intense as firms battle to increase their market shares by attracting competitors' customers. Certainly, this has been the case in the fast-food industry as explained in the Opening Case about McDonald's. McDonald's, Wendy's, and Burger King use their resources, capabilities, and core competencies to try to win each other's customers. The instability in the market that results from these competitive engagements may reduce the profitability for all firms engaging in such battles. As noted in the Opening Case, McDonald's has suffered from this competitive rivalry but is taking actions to rebuild its customer base and achieve a competitive advantage or at least competitive parity.

High Fixed Costs or High Storage Costs

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

Lack of Differentiation or Low Switching Costs

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

High Strategic Stakes

Competitive rivalry is likely to be high when it is important for several of the competitors to perform well in the market. Competing in diverse businesses (such as petrochemicals, fashion, medicine, and plant construction, among others), Samsung is a formidable foe for Apple in the global smartphone market. Samsung has committed a significant amount of resources to develop innovative products as the foundation for its efforts to try to outperform Apple in selling this particular product. Only a few years ago, Samsung held a sizable lead in market share. But in 2017, in the U.S. market, it was estimated that the iPhone achieved a holiday period market share of 31.3 percent while Samsung's Galaxy held 28.9 percent. Overall, these firms are in a virtual dead heat in the smartphone market.[116] Because this market is extremely important to both firms, the smart-phone rivalry between them (and others) will likely remain quite intense.

High strategic stakes can also exist in terms of geographic locations. For example, several automobile manufacturers have established manufacturing facilities in China, which has been the world's largest car market since 2009.[117] Because of the high stakes involved in China for General Motors and other firms (including domestic Chinese automobile manufacturers) producing luxury cars (including Audi, BMW, and Mercedes-Benz), rivalry among them in this market is quite intense.

High Exit Barriers

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

Common exit barriers that firms face include the following:

- Specialized assets (assets with values linked to a business or location)
- Fixed costs of exit (such as labor agreements)
- Strategic interrelationships (relationships of mutual dependence, such as those between one business and other parts of a company's operations, including shared facilities and access to financial markets)
- Emotional barriers (aversion to economically justified business decisions because of fear for one's own career, loyalty to employees, and so forth)

- Government and social restrictions (often based on government concerns for job losses and regional economic effects; more common outside the United States)

Exit barriers are especially high in the airline industry. Fortunately, profitability has returned to the industry following the global financial crisis and is expected to reach its highest level in 2018. Industry consolidation and efficiency enhancements regarding airline alliances helped reduce airline companies' costs. This, combined with improving economic conditions in several countries, resulted in a greater demand for travel. This has helped eased the pressures on several firms that may have been contemplating leaving the airline travel industry.[118]

2-5 Interpreting Industry Analyses

Effective industry analyses are products of careful study and interpretation of data and information from multiple sources. A wealth of industry-specific data is available for firms to analyze to better understand an industry's competitive realities. Because of globalization, international markets and rivalries must be included in the firm's analyses. And, because of the development of global markets, a country's borders no longer restrict industry structures. In fact, in general, entering international markets enhances the chances of success for new ventures as well as more established firms.[119]

Analysis of the five forces within a given industry allows the firm to determine the industry's attractiveness in terms of the potential to earn average or above-average returns. In general, the stronger the competitive forces, the lower the potential for firms to generate profits by implementing their strategies. An unattractive industry has low entry barriers, suppliers and buyers with strong bargaining positions, strong competitive threats from product substitutes, and intense rivalry among competitors. These industry characteristics make it difficult for firms to achieve strategic competitiveness and earn above-average returns. Alternatively, an attractive industry has high entry barriers, suppliers and buyers with little bargaining power, few competitive threats from product substitutes, and relatively moderate rivalry.[120] Next, we explain strategic groups as an aspect of industry competition.

2-6 Strategic Groups

A set of firms emphasizing similar strategic dimensions and using a similar strategy is called a **strategic group**.[121] The competition between firms within a strategic group is greater than the competition between a member of a strategic group and companies outside that strategic group. Therefore, intra-strategic group competition is more intense than is inter-strategic group competition. In fact, more heterogeneity is evident in the performance of firms within strategic groups than across the groups. The performance leaders within groups can follow strategies similar to those of other firms in the group and yet maintain strategic distinctiveness as a foundation for earning above-average returns.[122]

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

The notion of strategic groups can be useful for analyzing an industry's competitive structure. Such analyses can be helpful in diagnosing competition, positioning, and the profitability of firms competing within an industry. High mobility barriers, high rivalry, and low resources among the firms within an industry limit the formation of strategic groups.[123] However, after strategic groups are formed, their membership

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

Strategic **Focus**

Toys 'R' Us Exemplifies the Apocalypse in the Retail Industries

More than 10,000 stores closed in the United States in 2017. The companies that have gone bankrupt or are in serious financial trouble read like a list of Who's Who in retailing, The ones that could default in the near term include Sears, Neiman Marcus, Payless, J. Crew, PetSmart, and Steak 'n Shake, among others. But, perhaps the bankruptcy of Toys 'R' Us in 2018 caused the most angst among consumers because they remember what it used to be and know what it could have been.

Toys 'R' Us was a dominant retailer of toys that had devoted customers and toy manufacturers. The stores had every conceivable toy and became a 'one-stop-shopping destination' for most parents. It also reached out to and fostered the development of many small and medium sized toy manufacturers who largely owed their existence to Toys 'R' Us. At one time it was perhaps the most significant toy retailer in the world. As it grew, many of its competitors went out of business. Yet, after the founder stepped down from the CEO position, a succession of CEOs became complacent. Toys 'R' Us stopped analyzing its competitors, didn't invest in and update its stores, and began to lose the devotion of its customers. This made it vulnerable to new competition. Essentially, by ignoring competition and maintaining the status quo, it let competitors take advantage by better serving its customer base.

Large retailers such as Walmart and Target began to grow their toy sales and take market share away from Toys 'R' Us. And then Internet sales began to take market share. To respond, Toys 'R' Us signed an exclusive agreement to sell its toys over the Internet with Amazon. The contract was expensive (about $50 million annually), and Amazon did not only sell the toys from Toys 'R' Us. In fact, Amazon created an Internet marketplace selling multiple brands' and companies' toys. As such, Toy 'R' Us paid Amazon to become a substantial competitor.

Andrew Harrer/Bloomberg/Getty Images

Toys 'R' Us filed for bankruptcy in 2018, closing all of its stores.

At the height of these problems, Toys 'R' Us was sold to private equity investors who completed a leveraged buyout that saddled the company with substantial debt. With large debt payments, fewer resources were available to invest in the stores and to respond to competitors. Thus, in 2018 it filed for bankruptcy, closing all of its stores.

The exit of Toys 'R' Us leaves its two biggest competitors, Walmart and Amazon, now locked in a rivalry of their own.

Sources: H. Peterson, 2018, Retailers are filing for bankruptcy at a staggering rate—and these 19 companies could be the next to default. Business Insider, www.msn.com, March 18; 2018, Toys R Us built a kingdom and the world's biggest toy store. Then, they lost it, MSN, www.msn.com, March 17; 2018, Nostalgic shoppers shed tears over Toys 'R' Us demise, CNBC, wwwcnbc.com, March 15; M. Corkery, 2018, Toys 'R' Us case is test of private equity in age of Amazon, *New York Times*, nyti.ms/2DvabV5, March 15; M. Boyle, K. Bhasin & L. Rupp, 2018, Walmart-Amazon battle takes to Manhattan with dueling showcases, Bloomberg, Bloomberg.com, February 28; K Taylor, 2017, Here are the 18 biggest bankruptcies of the 'retail apocalypse' of 2017, Business Insider, www.businessinsider.com, December 20.

remains relatively stable over time. Using strategic groups to understand an industry's competitive structure requires the firm to plot companies' competitive actions and responses along strategic dimensions, such as pricing decisions, product quality, distribution channels, and so forth. This type of analysis shows the firm how certain companies are competing similarly in terms of how they use similar strategic dimensions.

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

As explained in the Strategic Focus, there is a massive 'train wreck' occurring in the retail industries. Former stalwarts such as Sears, Macy's, JCPenney, and Toys 'R' Us are all failing, largely because they ignored competition and it eventually caught up to them. Although other rivals began to erode their market share, the current problem revolves around the formidable Amazon. Amazon has been winning competitive battles against these weakened retailers, and even against other more formidable rivals Google and Walmart. Toys 'R' Us sowed the seeds of its demise a number of years ago by ignoring its competition. It was dominant in its industry, and then focused on growing its store base while paying little or no attention to what new competitors were doing. In fact, unknowingly it helped Amazon become a major competitor. The lesson in this for Amazon is that even highly successful firms must continuously analyze and understand their competitors if they are to maintain their current market leading positions. If Amazon continues to effectively analyze its competition across industries, the question becomes, can any of its rivals beat it?[124]

2-7 Competitor Analysis

The competitor environment is the final part of the external environment requiring study. Competitor analysis focuses on each company against which a firm competes directly. The Coca-Cola Company and PepsiCo, Home Depot and Lowe's, Carrefour SA and Tesco PLC, and Amazon and Google are examples of competitors that are keenly interested in understanding each other's objectives, strategies, assumptions, and capabilities. Indeed, intense rivalry creates a strong need to understand competitors.[125] In a competitor analysis, the firm seeks to understand the following:

- What drives the competitor, as shown by its *future objectives*.
- What the competitor is doing and can do, as revealed by its *current strategy*.
- What the competitor believes about the industry, as shown by its *assumptions*.
- What the competitor's capabilities are, as shown by its *strengths* and *weaknesses*.[126]

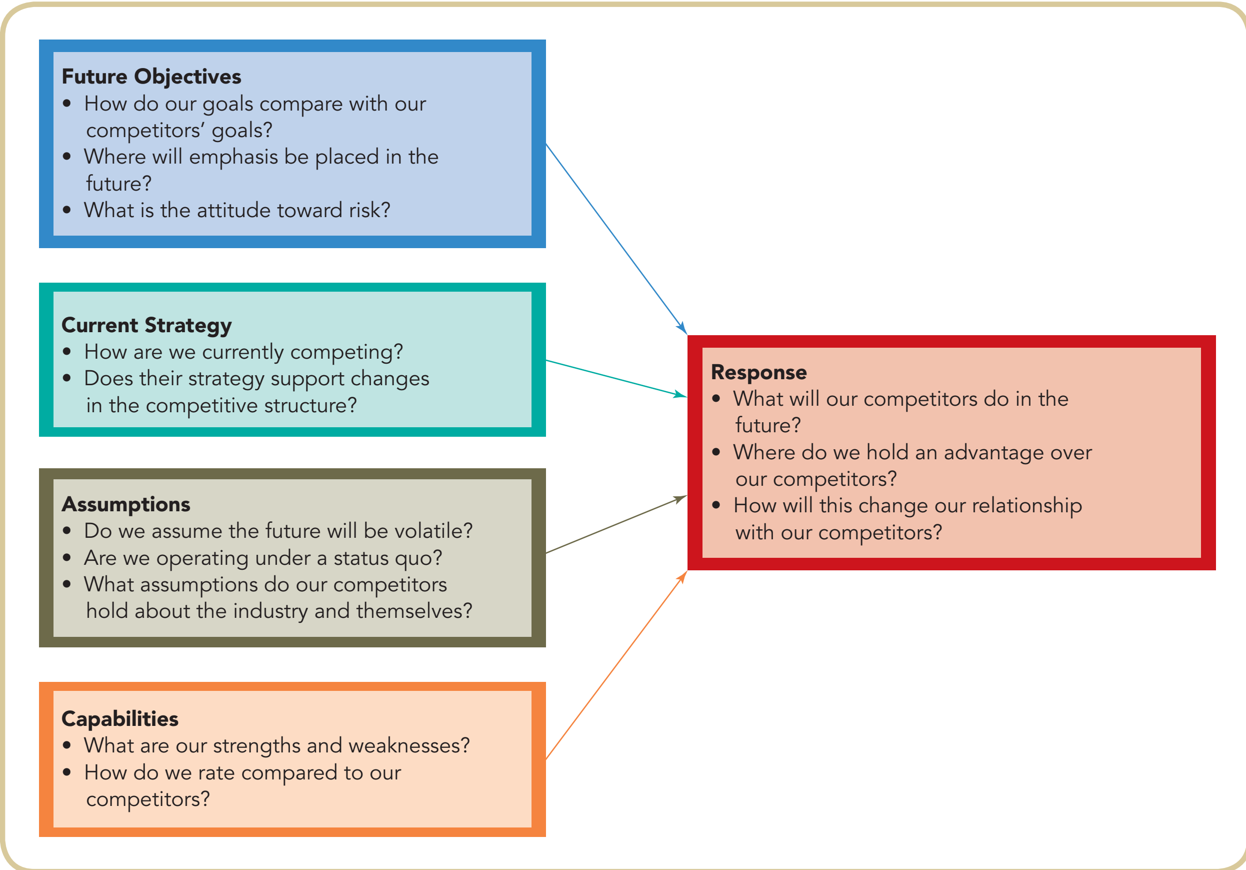
Knowledge about these four dimensions helps the firm prepare an anticipated response profile for each competitor (see Figure 2.3). The results of an effective competitor analysis help a firm understand, interpret, and predict its competitors' actions and responses. Understanding competitors' actions and responses clearly contributes to the firm's ability to compete successfully within the industry.[127] Interestingly, research suggests that executives often fail to analyze competitors' possible reactions to competitive actions their firm takes,[128] placing their firm at a potential competitive disadvantage as a result.

Critical to an effective competitor analysis is gathering data and information that can help the firm understand its competitors' intentions and the strategic implications resulting from them.[129] Useful data and information combine to form **competitor intelligence**, which is the set of data and information the firm gathers to better understand and anticipate competitors' objectives, strategies, assumptions, and capabilities. In competitor analysis, the firm gathers intelligence not only about its competitors, but also regarding public policies in countries around the world. Such intelligence facilitates an understanding of the strategic posture of foreign competitors. Through effective competitive and public policy intelligence, the firm gains the insights needed to make effective strategic decisions regarding how to compete against rivals.

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

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

Figure 2.3 Competitor Analysis Components



that competitive intelligence appears to involve trade-offs.[130] The reason for this is that "what is ethical in one country is different from what is ethical in other countries." This position implies that the rules of engagement to follow when gathering competitive intelligence change in different contexts.[131] To avoid the possibility of legal entanglements and ethical quandaries, firms must govern their competitive intelligence gathering methods by a strict set of legal and ethical guidelines.[132] Ethical behavior and actions, as well as the mandates of relevant laws and regulations, should be the foundation on which a firm's competitive intelligence-gathering process is formed.

When gathering competitive intelligence, a firm must also pay attention to the complementors of its products and strategy.[133] **Complementors** are companies or networks of companies that sell complementary goods or services that are compatible with the focal firm's good or service. When a complementor's good or service contributes to the functionality of a focal firm's good or service, it in turn creates additional value for that firm.

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

There are many examples of firms whose good or service complements other companies' offerings. For example, firms manufacturing affordable home photo printers complement other companies' efforts to sell digital cameras. Intel and Microsoft are perhaps the most widely recognized complementors. The two firms do not directly buy from or sell to each other, but their products are highly complementary.

Alliances among airline companies such as Oneworld and Star involve member companies sharing their route structures and customer loyalty programs as a means of complementing each other's operations. (Alliances and other cooperative strategies are described in Chapter 9.) In this example, each of the two alliances is a network of complementors. American Airlines, British Airways, Finnair, Japan Airlines, and Royal Jordanian are among the airlines forming the Oneworld alliance. Air Canada, Brussels Airlines, Croatia Airlines, Lufthansa, and United Airlines are five of the members forming the Star alliance. Both alliances constantly adjust their members and services offered to better meet customers' needs.

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

2-8 Ethical Considerations

Firms must follow relevant laws and regulations as well as carefully articulated ethical guidelines when gathering competitor intelligence. Industry associations often develop lists of these practices that firms can adopt. Practices considered both legal and ethical include:

1. Obtaining publicly available information (e.g., court records, competitors' help-wanted advertisements, annual reports, financial reports of publicly held corporations, and Uniform Commercial Code filings)
2. Attending trade fairs and shows to obtain competitors' brochures, view their exhibits, and listen to discussions about their products

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

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

Professional associations are available to firms as sources of information regarding competitive intelligence practices. For example, while pursuing its mission to help firms make "better decisions through competitive intelligence," the Strategy and Competitive Intelligence Professionals association offers codes of professional practice and ethics to firms for their possible use when deciding how to gather competitive intelligence.[134]

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

SUMMARY

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

KEY TERMS

competitor analysis 40
competitor intelligence 63
complementors 64
demographic segment 43
economic environment 46
general environment 39
global segment 50
industry 53
industry environment 39
opportunity 41
political/legal segment 47
sociocultural segment 48
strategic group 61
sustainable physical environment segment 51
threat 41
technological segment 49

REVIEW QUESTIONS

1. Why is it important for a firm to study and understand the external environment?
2. What are the differences between the general environment and the industry environment? Why are these differences important?
3. What is the external environmental analysis process (four parts)? What does the firm want to learn when using this process?
4. What are the seven segments of the general environment? Explain the differences among them.

5. How do the five forces of competition in an industry affect its profitability potential? Explain.
6. What is a strategic group? Of what value is knowledge of the firm's strategic group in formulating that firm's strategy?
7. What is the importance of collecting and interpreting data and information about competitors? What practices should a firm use to gather competitor intelligence and why?

Mini-Case

Watch Out All Retailers, Here Comes Amazon; Watch Out Amazon, Here Comes Other Competitors

Amazon's sales in 2014 were $88.99 billion, an increase of 19.4 percent over 2013. In fact, its sales in 2014 were a whopping 160 percent more than its sales in 2010, only four years prior. Amazon has been able to achieve remarkable gains in sales by providing high quality, rapid, and relatively inexpensive (relative to competitors) service. Amazon has taken on such formidable competitors as Walmart, Google, and Barnes & Noble, among others, and has come out of it as a winner, particularly in the last 4–5 years.

Walmart has been emphasizing its online sales as well. In 2014, it grew online sales by about $3 billion, for a 30 percent increase. That seems like excellent progress, until one compares it to Amazon's sales increase in 2014 of about $14.5 billion. Much opportunity remains for both to improve as total 2014 online sales were $300 billion.

Google is clearly the giant search engine with 88 percent of the information search market. However, when consumers are shopping to purchase goods, Amazon is the leader. In the third quarter of 2014, 39 percent of online shoppers in the United States began their search on Amazon, compared to 11 percent for Google. Interestingly, in 2009 the figures were 18 percent for Amazon and 24 percent for Google. So, Amazon appears to be winning this competitive battle with Google.

Barnes & Noble lost out to Google before by ignoring it as a threat. Today, B&N has re-established itself in market niches trying not to compete with Google. For example, its college division largely sells through college bookstores, which have a 'monopoly' location granted by the university. However, Amazon is now targeting the college market by developing agreements with universities to operate co-branded websites to sell textbooks, university t-shirts, etc. Most of the students already shop on Amazon, making the promotion easier to market to universities and to sell to students.

A few years ago, Amazon was referred to as the Walmart of the Internet. But, Amazon has diversified its product/service line much further than Walmart. For example, Amazon now competes against Netflix and other services providing video entertainment. In fact, Amazon won two Golden Globe Awards in 2015 for programs it produced. Amazon also markets high fashion clothing for men and women. Founder and CEO of Amazon, Jeff Bezos, stated that Amazon's goal is to become a $200 billion company, and to do that, the firm must learn how to sell clothes and food.

It appears that Amazon is beating all competitors, even formidable ones such as Google and Walmart. But, Amazon still needs to carefully watch its competition. A new company, Jet.com, is targeting Amazon. Jet.com was founded by Marc Lore, who founded the highly successful Diaper.com and a former competitor of Amazon, Quidsi. Amazon hurt Quidsi in a major price war and eventually acquired the company for $550 million. Lore worked for Amazon for two years thereafter but eventually quit to found Jet.com. Jet.com plans to market 10 million products and guarantee the lowest price. Its annual membership will be $50 compared to Amazon Prime's cost of $99. Competing with Amazon represents a major challenge. However, Jet.com has raised about $240 million in venture funding with capital from such players as Bain Capital Ventures, Google Ventures, Goldman Sachs, and Norwest Venture partners. Its current market value is estimated to be $600 million. The future competition between the two companies should be interesting.

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Mini-Case Questions

1. Can any firm beat Amazon in the marketplace? If not, why not? If so, how can they best do so?
2. How formidable a competitor is Google for Amazon? Please explain.
3. What are Amazon's major strengths? Does it have any weaknesses? Please explain.
4. Is Jet.com a potential concern for Amazon? Why or why not?

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