Understanding the External Environment

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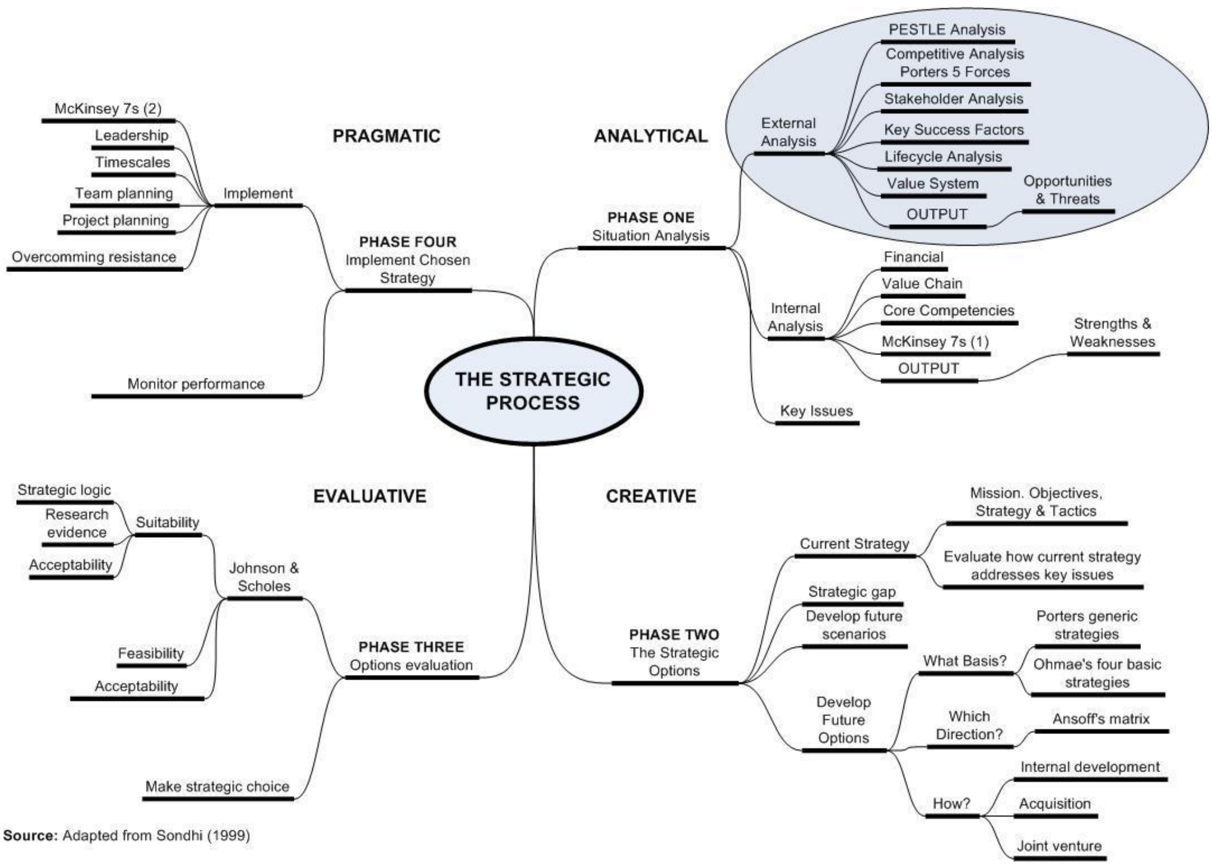
If you knew everything about tomorrow, what would you do differently today?

In this time of great uncertainty, many companies and their executives are wondering which changes will have the greatest impact on their businesses in the year/years ahead. What is certain is that the threats and opportunities facing any business, which fall out of change and uncertainty in the environment, can impact directly upon the profitability and even the very survival of those businesses. Some companies will have experienced such damage from the recession that they will be unable to recover as the economy revives. It is imperative to be alert to change, recognise it and deal fittingly and decisively with important issues identified. Perhaps never has this been more important! This paper considers the analysis and understanding of the external environment within the context of the strategic process.

It is useful to consider the notion that the business environment conforms to an ecosystem, very similar to that of the natural world. Scientists better understand ecosystems in nature by looking at individual elements, how they move, and how each of the elements relates to one another. "As in nature, when one element of the ecosystem dynamically changes, the effect cascades right throughout the whole environment"[1]. The same dynamics apply in the business world.

Figure 1: The Strategic Process



Source: Adapted from Sondhi (1999)

The notion of a business ecosystem steers us to look at the strategic process (Figure 1) as something that needs to be contemplated holistically, as a whole, rather than just the individual parts, separately.

The strategic process includes the external and the internal environment which interact with each other in a relatively seamless way. “There is little point in building a strategy that focuses entirely on either an external or an internal perspective, as many of the key drivers will be bypassed, leading to ineffective strategies”[2]. Building a strategy that focuses insufficiently on each stage of the process, in its entirety, “will lead to incomplete solutions” (ibid). Senge, the guru of systems thinking describes this as a discipline for seeing wholes and a framework for seeing interrelationships rather than things, for seeing patterns of change rather than static snapshots. The world today has become more engulfed by uncertainty and because of this, more than ever, systems thinking is required[3].

Environmental analysis can be described as “the study of the organisational environment to pinpoint environmental factors that can significantly influence organisational operations.[4]" With this type of analysis it is possible to improve understanding of the makeup and extent of uncertainty in the environment, to figure out the opportunities available worth seizing and the threats that need to be dealt with. It provides executives with a high degree of sensitivity to signals from the environment, allowing businesses to react strategically ahead of time. It enables businesses to match their capabilities to the external environment through creating and implementing relevant strategy. It allows proactive management to establish the extent to which it can increase the control of the business over its environment. It also helps provide an understanding of the key dynamics at play both inside and outside the business. It increases the chances that the strategy developed will provide an apt response to the environment. In essence, it is essential that executives rigorously analyse their environment, identify, anticipate and if possible influence environmental change[5].

It is important to fully understand how the environment is structured to carry out such analysis. There are three clear levels: the macro-environment; the industry (or sector) environment; and the competitive/market environment. Phase one of the strategic process, the situation analysis, sets out to focus on understanding the external environment. The key task here is to get a good grasp of what is happening in the general environment, so as to determine the key drivers of change not only in Ireland but also worldwide and within the industry and related industries. The output from this exercise will provide a list of opportunities and threats facing the business following which important implications for the business can be assessed. It also sets out to understand the company’s internal environment, clearly defining its strengths and weaknesses. From this “SWOT” analysis, an identification and prioritisation of the key strategic issues facing the business can be assessed. An analysis of the current strategy can then be carried out with a view to establishing how well it addresses the key issues identified.

<u>As an aid to identifying the external forces the following tools are helpful:</u>

1) **PESTLE Analysis**

What is happening in the world and domestic economy sets the context for businesses but economic developments are influenced by political, social, technological, legal and environmental factors. The objective of carrying out such an analysis is to determine the key external environmental influences on that business and to examine the impact of these influences.

A rewarding and useful PESTLE analysis is much more than just a checklist of items. It is relatively easy to pull together a long list of factors from the macro-environment that may influence the future of any business. However, such a list is not helpful or indeed useful when attempting to gain a richer understanding of the dynamics at play. More examination and determination of the key drivers of change is required. “The challenge is to reduce long lists to shorter ones, to develop a good understanding of how each influence might play out in the future, and the way in which this would affect the firm”[6].

Some businesses, for example the pub business in Ireland, have learned at some considerable expense, the pitfalls of defining their environment too narrowly. Some major companies have shown themselves to be blinkered to significant change in the environment, while others have invested heavily in research, consulting, databases and computer models, leading to “paralysis by analysis‟ and tardy decision making. Judgement and common sense is essential to make best use of the resources available in carrying out such an analysis, and to ensure that all involved are alert to their own subconscious biases or “blind spots‟ (ibid). For example, a study conducted four years ago by sustainable business experts Envirowise found that 44% of companies in London expected “no change‟ in the environmental awareness of customers in the near future, even though the UK market for green goods and services at the time exceeded an annual £29 billion and rising, according to the Co-operative Bank[7].

With such an abundance of information available today, the Influence/Impact matrix is a useful tool to assist the analyst prioritise the drivers identified in the PESTLE and subsequent analysis. However, it is important to note that if the drivers are not clear or definite, then the process of prioritising the factors becomes much more difficult[8].

Figure 2: Influence/impact matrix

Driver	Influence on industry (0 to 10)	Impact on company (-5 to+5)	Threat to strong opportunity (-50 to +50)	Notes
	(A)	(B)	(A)x(B)	

Source: Sondhi (1999)

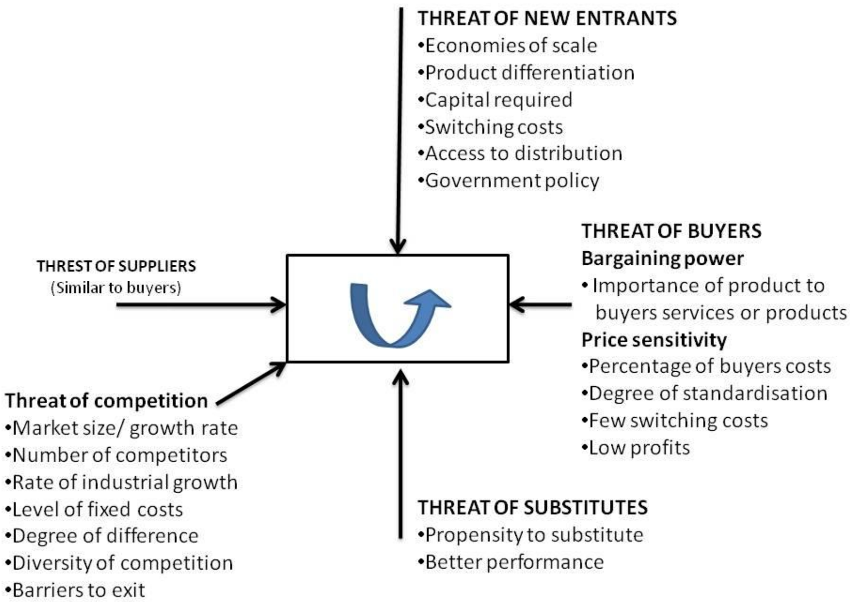
Resources for students which might be useful for a PESTLE analysis include: college libraries and databases, the web, trade ejournals, company annual reports and industry sector reports.

An exploration and appraisal of stakeholder interests may also help focus this analysis, as perhaps will expert opinion. Another method to provide focus is to identify the “key success factors‟ in the industries where the business competes (see below).

2) **Porters Five Forces**

The main purpose of this model is to analyse industry attractiveness in order to forecast industry profitability. Porter claims that there are essentially five forces which determine the underlying structure of an industry i.e. rivalry between existing players, the bargaining power of buyers, the bargaining power of suppliers, the threat of new entrants into the business and the threat of substitute products. Each can have a positive or negative effect on an industry structure by making it either more or less competitive. By examining each force and the balance between them, it is possible to determine the overall level of competition and therefore the overall attractiveness of the industry. The collective strength of the forces determines the ultimate profit potential in the industry.

Figure 3: Porter's five forces analysis



A major output of the analysis is to identify the key players and competitors within the defined industry. In fact, a detailed analysis of the strengths and weaknesses of the companies along the lines of the analysis carried out for one's own business can be followed.

3) **The stakeholder analysis**

Business is about creating value for all those engaged in it, each of whom possess interests that vary considerably e.g. shareholders (whose goal is profit), top management (whose goals include salary, perks, prestige and power), and employees who are interested in pay, working conditions, and job security). External stakeholders include creditors, customers, unions, local communities, government, suppliers, competitors, public interest groups. All of these have important interests[9]. The stakeholder therefore is a key component of any business and so the ability to manage the needs and expectations of the group of people most heavily associated with the industry is a necessity.

The purpose of stakeholder analysis is to determine the assumptions the various stakeholder groups make about an industry. Some will support the industry and as a result create opportunities, while others will resist and present threats. Hence the necessity to carry out an analysis of stakeholder needs once a strategy has been agreed or is being implemented[10]. The task is to determine each stakeholders assumptions both supporting and resisting, and to place each on a grid (Figure 4), evaluating the importance of each assumption on the strategy and the extent of certainty supporting it. A scale of 0 to 10 can be used for both criteria, with 0 representing low importance and low certainty and 10 representing high importance and high certainty.

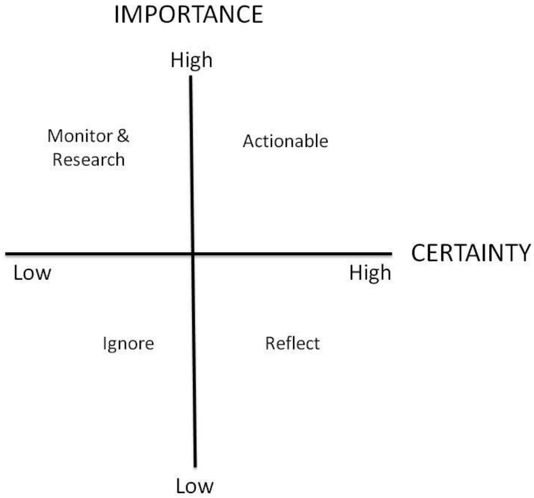
Figure 4: Stakeholder assumptions

Stakeholders	Major assumptions	Importance	Certainty
A	Supporting		
	Resisting		
B			

Source: Sondhi (1999)

Placing the data collected on the graph below will highlight the key factors that need consideration. Identifying these assumptions will enable the provision of a force-field analysis and a decision on the best way to use the forces supporting the strategy to fight off the forces likely to resist the strategy.

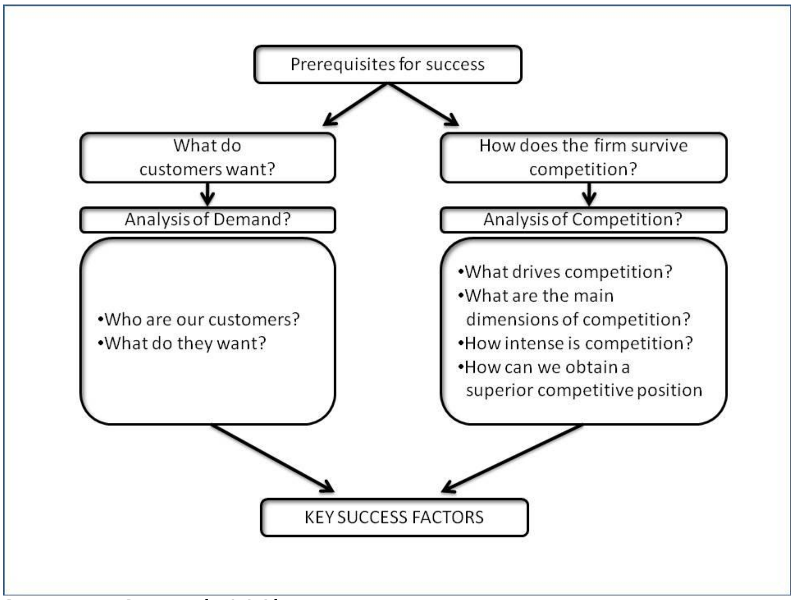
Figure 5: Presenting competitor data, space diagrams



Source: Sondhi (1999)

4) **Key Success factors**

Figure 6: Identifying Key Success Factors



Source: Grant (1998)

Key success factors (KSF" s) are defined by Grant as "the factors that are important in determining a firm' s ability to survive and prosper"[11]. He suggests identifying KSF" s by asking two questions. 1) What do customers want? 2) What does the firm need to do to survive competition? To answer question 1 Grant suggests looking closely at customers of the industry, seeing them less as a source of bargaining power and as such, a threat to profitability, and more the fundamental reason for the existence of the industry and the central source of profits. The suggestion here is that businesses need to know their customers intimately, be able to identify and even anticipate their needs, and clearly establish the basis of how they select one supplier's offerings in preference to that of another. This can then be the starting point for a chain of analysis. For example for a supermarket group this might shape up as follows:

- What do customers want? Low prices; convenient location; wide range of products; product range adapted to local customer preferences; freshness of produce; cleanliness; service; and pleasant ambience.
- How does the supermarket survive competition? Localised markets and concentration normally high; vigorous price competition; exercise of bargaining power/ important influence on input cost; scale economies.
- KSF' s: Low cost operation requires operational efficiency, scale efficient stores; large aggregate purchases to maximise buying, low wage costs; differentiation requires large stores power (to allow wide product range), convenient location, easy parking.

Grants second question takes a look at the basis for competition within the industry, the nature of its intensity and its key elements. If competition is intense and even if the product is highly differentiated and if consumers choose on a range of value benefits, such as design and quality rather than on price, low cost may still be a prerequisite to the survival of the business. For example, in a fiercely competitive retail sector retailers such as Brown Thomas and Marks & Spencers do not compete on low prices, but their prosperity depends on rigorous cost control.

A basic framework for identifying key Success factors is presented in Figure 6. In the banking sector key success factors include: customer service, technology, risk management and capital adequacy. Once key success factors have been identified, the PESTLE analysis can be built around the broad issues which impact on them. It is interesting to note the banks that failed on some of these dimensions in recent times.

To complete the situation analysis an internal analysis needs to be completed as outlined in Figure 1 with a view to establishing an understanding the internal strengths and weaknesses of the business. This will enable the completion of the SWOT.

In attempting to identify the key strategic issues facing the business, it is important to seek out the relationship between the elements, as noted earlier. Questions should be posed for various combinations of the elements that might be telling regarding the future direction of a business. A useful question to pose is "what are the implications"? For example, what are the implications if demographic trends show the population aging with senior citizens becoming a more significant element of the market and our product representation in the sector is weak? What are the implications if information technology developments are providing a means to make considerable productivity gains in the sector and we have limited cash resources and no plans in the pipeline? What are the implications if the market we operate in is falling in volume and we are compelled to match heavy price competition?

In phase two (strategic options) of the strategic process (see Figure 1), the first step is to establish if the current strategy adequately addresses the key issues identified. Future scenarios should be developed with a view to establishing what the future might hold and have a reasonable probability of occurrence. This assists in ensuring that the business develops a reasoned strategy that is consistent with the current environment. One scenario is eventually chosen and should be the most likely and ideally the most desired.

Every company faces a huge number of options as to how it can deploy its resources to compete in the market place. There are three main types of strategic decision a firm has to make:

1. Generic strategy decisions. (Porters generic strategies)
2. Decisions covering alternative growth options/ directions. (Ansoff's matrix).
3. Decisions about alternative growth methods - internal development, acquisition and joint venture.

In phase three (options evaluation) of the strategic process (see Figure 1) Johnson & Scholes propose a two-stage process of strategic choice. First a shortlist of suitable strategic options should be drawn up. These options should then be screened for suitability, feasibility and acceptability[12].

In phase four (implement the chosen strategy) of the strategic process (see Figure 1) this last step should be aimed to ensure that the chosen strategy can be implemented and will work. It is as essential to a business as analysis is and the choice of the best solution. Concepts that will help in this regard include:

- McKinsey 7s:
  This model identifies seven interrelated dimensions that determine a business's effectiveness – strategy, structure, systems, skills, staff, style and super-ordinate goals. It is important to understand the strategic interplay between the elements. All of the seven S" s are interconnected. As one is changed, it will have an influence on the others. What changes need to be made?
- Leadership planning and development within the organisation
- Timescales

- Managing change through projects offers a cross-functional approach and through the use of project management techniques will provide a manager with ready-made techniques for problem diagnosis and solving, decision making, planning, budgeting, control and the implementation of change without establishing permanent structures.
- Team planning.

In conclusion, never has it been more important for businesses to recognise and anticipate change in their ecosystems and to act accordingly. They do not necessarily have to follow the potentially more fruitful opportunities but perhaps a better outcome might be achieved by establishing a fit between the strengths of the business and the opportunities identified. It may even be possible for a business to surmount a weakness so that it can follow a particularly attractive opportunity.

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