

# Chapter 2: External Environment Analysis: Opportunities and Threats

## Learning Objectives

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Studying this chapter should provide you with the knowledge t

- Explain the importance of correctly identifying and choosing a firm's industries and markets.
- Identify and measure the five major forces that shape average firm profitability within industries to evaluate the overall attractiveness of an industry.
- Identify the factors in the general environment that affect firm and industry profitability.

## Professors Purpose

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The purpose of this chapter is to introduce students to the forces that influence inter- and intra-industries. Students will learn how to apply Michael Porter's Five Forces framework to evaluate the attractiveness of industries in the broader scope of the general environment. The Five forces framework will be basis of analysis for the remainder of the course.

This strategy tool will be learned through class lecture, end of chapter assignments, mini-cases in chapter and finally with the Coca Cola case.

Please note that the "Presenters Notes" are in the PowerPoint slide deck give a brief script for lecture and can be used as a guide.

## Answers to Review Questions

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1. Why is it important for a firm to accurately determine what industry it is in?  
*So that executives can identify who their real competitors are and the economic forces that will influence the strategies they hope to pursue. Industries also differ in terms of their profitability and performance, and identifying the right industry tells managers and investors what types of returns to expect.*
2. How should a firm decide what industry it is in?  
*Firms should use the U. S. Government's NAICS codes to determine their industry.*
3. What are the five major industry forces? How do they shape average profitability in an industry?

*The five forces are: Barriers to (or threat of) Entry, Supplier Power, Buyer Power, Presence of Substitutes, and Competitive Rivalry. The impacts on average profitability are*

*Threat of Entry—the lower the threat the higher the average profitability*

*Supplier Power—the lower supplier power, the higher the average profitability*

*Buyer Power—the lower buyer power, the higher the average profitability*

*Substitution—the lower the threat of substitution, the higher the average profitability*

*Rivalry—the lower the degree of rivalry, the higher the average profitability.*

4. What factors determine the intensity of rivalry?  
*(1) the number and size of competitors; (2) standardization and perishability of products; (3) costs to buyers of switching to another product; (4) growth in demand for products; (5) levels of unused production capacity or fixed costs; and (6) the difficulty for firms of leaving the industry.*
  
5. Explain why increased buyer concentration would increase buyer power.  
*Increased buyer concentration (fewer buyers relative to the number of sellers) gives buyers increased pricing leverage over the firm. This is because firms have to compete to sell to fewer buyers, and orders tend to be larger.*
  
6. Explain what it means for suppliers to have a credible threat of forward integration.  
*This happens when a supplier can easily compete with the firm. It may have the same technology, or it may already have access to the same distribution system. With very little expenditure, the supplier could produce and sell the same product as the firm.*
  
7. What factors determine the intensity of the threat of new entrants?  
*The presence of economies of scale, experience, or learning; other cost advantages; Capital requirements to enter the industry; network effects, government policies and regulations.*
  
8. What are substitutes?  
*A product that is fundamentally different yet serves the same basic function or purpose as another product*
  
9. What are the seven general environmental factors that affect industry profitability?  
*Complementary products or services  
 Technological change  
 General economic conditions  
 Population demographics  
 Global competitive forces  
 Political, legal, and regulatory forces,  
 Social/Cultural forces  
 Ecological/Natural Environment*

10. How does each of the eight general environmental factors influence industry profitability?

*Complementary products or services—raise the attractiveness of the industry's products, and hence its price*

*Technological change—technology can either enhance profitability (by creating new complements) or it can destroy profitability by creating a new and better substitute product.*

*General economic conditions—General economic conditions, such as interest rates, affect the cost of capital as well as consumer's overall willingness to spend.*

*Population demographics—affect the composition, and number, of customers. An aging population is bad for toys and games, but good for vacations and retirement living.*

*Global competitive forces—Global competitive forces can drive down profitability by removing trade barriers and inviting global competitors to enter the market. However, globalization also helps profitability by giving firms access to new, and sometimes very large, markets.*

*Political, legal, and regulatory forces—Regulations can increase the costs of doing business, or make some products and services less attractive to buyers. Conversely, government regulations can also raise barriers to entry and increase industry profitability.*

*Social/Cultural forces—this force influences consumer tastes and preferences. Changes in tastes can reduce profitability (think of the fast food industry), or it can raise profitability (think of all the accessories that make your smartphone more attractive and easier to use).*

*Ecological/Natural Environment—emerging concerns about the natural environment may open new and profitable industries, such as renewable energy. Threats of ecological damage can invite government regulations or activist concerns. These would drive down profitability.*

11. How do the eight general environmental factors affect the five industry forces?

*The general environmental forces work primarily to make the five forces dynamic. Often it is changes in the larger environment that causes a significant shift in each of the 5 forces.*

12. What are the elements of a complete external analysis?

*Managers should begin by defining the industry. They should then analyze and evaluate the 5 forces, and then they should examine the current—and future—impacts of the eight general environmental forces on the industry. It is important to understand how the industry has evolved over time, and so a complete analysis will consider how each force or element has changed over time, and what future changes might be reasonable.*