Strategic Management for Organizations

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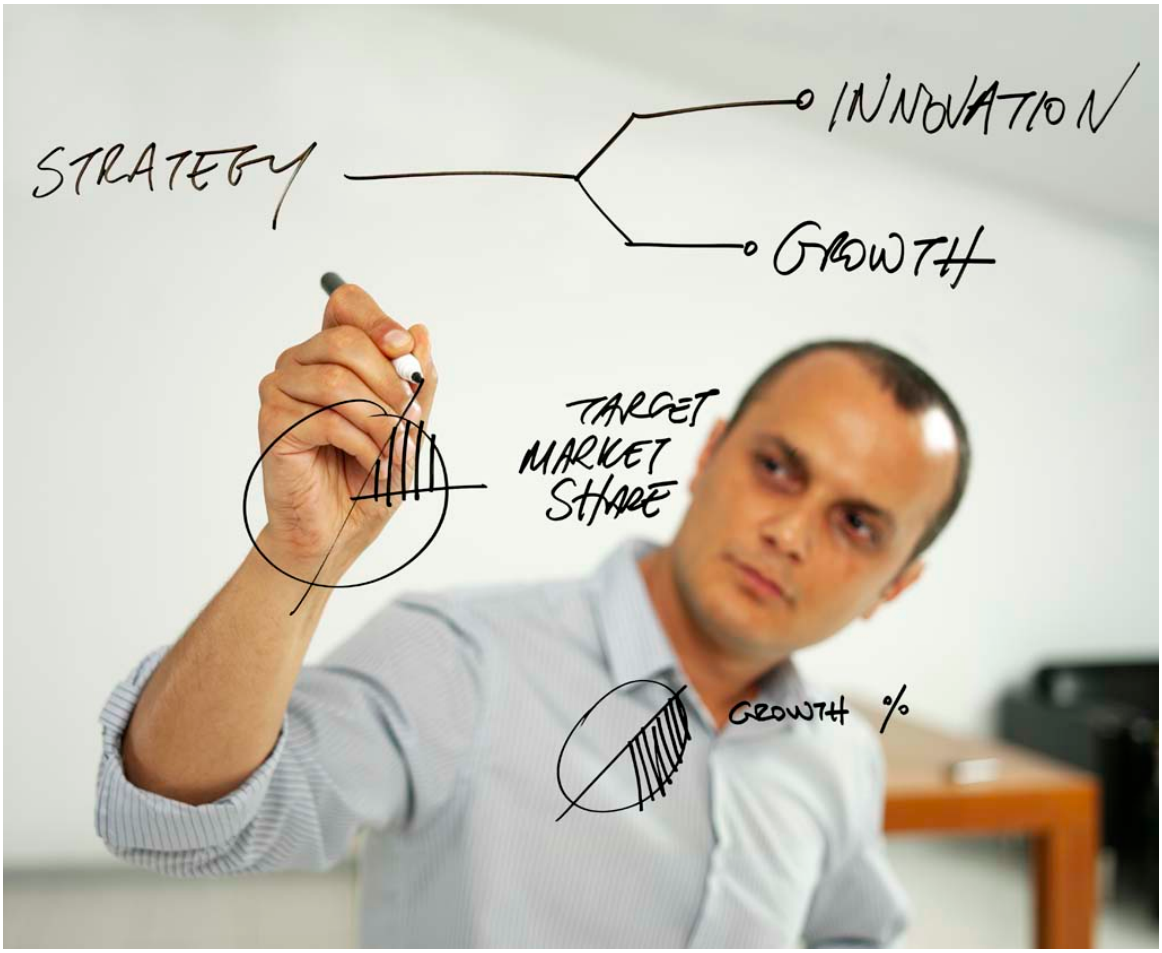
Chapter 3

Strategic Thinking



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Learning Objectives

By the time you have completed this chapter, you should be able to do the following:

- Understand how complex strategic thinking is, and appreciate why one cannot do strategic planning without it.
- Learn how to go about finding a better strategy through identifying viable opportunities.
- Identify situational monopolies or unique market spaces with no competitors.
- Learn how to create viable scenarios so that strategic decisions might be

made taking into account alternative likely futures.
- Learn how to go about finding a better business model.

Strategic thinking is part of the strategic-planning process, which itself is part of the strategic-management process. This chapter describes what is involved in doing strategic thinking and why it should be done year round, not just when doing strategic planning. It includes many tools and techniques useful in finding and evaluating opportunities as well as trying to understand which of several futures might unfold.

3.1 Purpose of Strategic Thinking

Company and business owners need a clear picture of the next few years in the life of the company in order to make decisions so that the company can continue to prosper. Not surprisingly, the further into the future one looks, the more potential outcomes have to be considered.

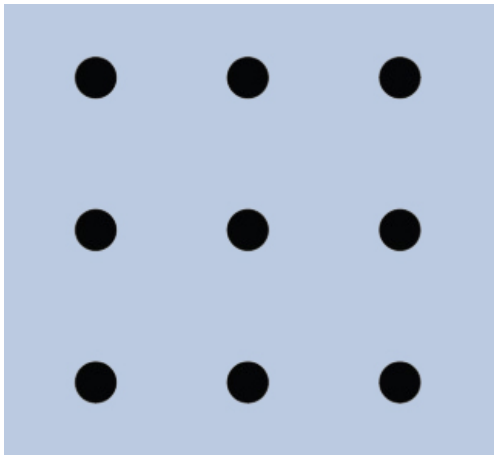
What does strategic thinking *really* mean? To be sure, it implies **thinking outside the box** and not limiting oneself to conventional ideas. One pioneering approach to creativity developed by Edward De Bono is called lateral thinking.

Edward De Bono likens the process to a game of chess, which uses a standard set of pieces on a standard grid. He argues that, in life, the pieces are not a given even though we may perceive them as such. To engage in lateral thinking the object is not to play with the existing pieces but to change the actual pieces themselves. Strategic thinking may also have something to do with "seeing the big picture," or being able to distinguish between "the forest and the trees." Some strategy consultants use the analogy of a helicopter ride that takes one up to a sufficient height to see the big picture, the road beyond the turns, and the hills that, from ground level, are not visible. Some even take managers through lateral thinking and creativity exercises to "free up" people's thinking, implying that to do these things is to think strategically. While these activities may be useful, they are not sufficient, and *they do not constitute strategic thinking*. (To learn more about lateral thinking, see De Bono, 1970, 1971, and 1992.)

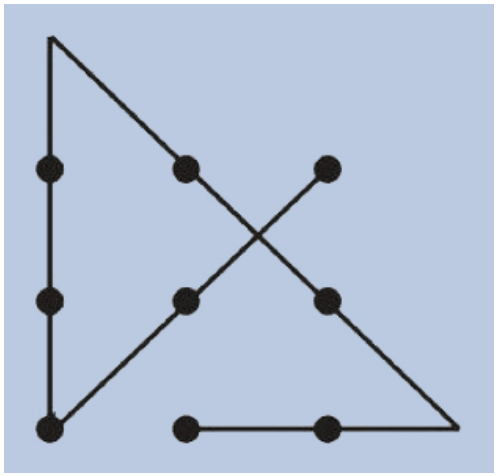
Earlier, it was noted that a company could operate with a plan rather than with a strategy if it did not have to compete. The term *strategy* signifies the need to contend with and outwit competition. Therefore, strategic thinking involves finding unique ways to compete and provide customer value. In other words, strategic thinking entails coming up with better strategies and business models.

The Origin of "Thinking Outside the Box"

A phrase we often hear used casually in everyday speech in business, "thinking outside the box" is a useful metaphor for communicating how ordinary people can actually create extraordinary value when working together in organizations. The phrase comes from a famous puzzle in mathematics known as the nine-dot problem. Visualize a page with nine dots arrayed in three rows of three dots each. The objective is to draw four straight lines that connect all of the dots, without lifting your pencil from the paper.



The puzzle seems intractable because we immediately assume we are bound by the imaginary square in which the nine dots are arrayed. Of course the puzzle is impossible to solve with that constraint, but the instructions never mentioned any restriction. Most people simply assume this boundary and thus are limited by their perceptions or mental model. The solution requires that three of the four lines extend outside the space defined by the outmost dots (see below). Hence, the metaphor "thinking outside the box" refers to thinking outside of the normal mental models that influence the way we view the world.



For example, consider Starbucks. In a March 2011 interview, CEO Howard Schultz admitted that the rapid growth of the chain had become a "carcinogen" on its overall health. He reflected:

"Growth should not be, and is not, a strategy. It's a tactic." He recalled visiting a Starbucks store and finding a table of teddy bears for sale. Concerned that this type of merchandise had nothing to do

with coffee, he queried the manager of the store who explained that the bears were boosting the store's monthly sales. Schultz realized that the coffee chain had strayed far from its mission and values in its emphasis on this sales metric, which is but one way to measure the health of an organization. In response, Schultz and his team had to engage in a new line of strategic thinking to create better strategies that would deliver customer value and satisfaction and bring the chain back to its roots (Webb, 2011).

It is not possible to create a strategy without using strategic thinking. The quest to find workable alternative strategies—one component of the strategic-planning process—is essentially strategic thinking in action. Discovering the strategy that is "right" for a company can result in a higher market share, a new competitive edge, or discovery of an uncontested market space, all of which is accomplished through strategic thinking. In the Starbucks example, after a period of strategic thinking, Schultz announced the end of monthly comparative sales reporting, and the chain shifted its merchandising to products that were tied to coffee, such as the now-popular "Via" instant coffee. Shultz and his team strategically figured that if they could "integrate Via and other products into the emotional connection we have with customers in our stores," they could launch a new model that would still feed the bottom line but in a way that is consistent with the organization's mission. Even being able to choose the industry or to dictate the rules of competition, should the company be so fortunate, are legitimate outcomes of strategic thinking (Webb, 2011).

Strategic thinking is not just "thinking" or "blue-skying," but trying to find different and better ways of competing, of delivering customer value, and of growing—that is, thinking with some purpose in mind. Without such thinking and absent many years of experience, coming up with alternative strategies or business models and choosing a preferred or "best" one becomes considerably more difficult. The following sections go into more detail about how to engage in strategic thinking.

Discussion Questions

1. Chatting with a guest over dinner, you learn that he manages a small business and that, as this is a new experience for him, he feels somewhat overwhelmed. How might your knowledge of strategic thinking help him?
2. Is being highly creative the same as being a good strategic thinker? Why or why not?
3. What might be an apt analogy for trying to do strategic planning without doing any strategic thinking?
4. If a company did only strategic thinking, would it need to do strategic planning? Discuss.

3.2 Finding Better Strategies

Having discussed the range of potential business strategies in Chapter 1, we shall next examine how companies can make decisions about which strategy or strategies work best for them. Searching for a better strategy could simply mean "look at strategies we aren't currently pursuing and see whether adopting any of them makes any sense for us." In meaningful terms, however, the challenge is more complex. In this section, we explore three ways of thinking that would yield better results:

- Play a different game
- Be entrepreneurial
- Find more opportunities

Play a Different Game

Strategy is all about standing out from the competition by finding a unique way to dominate the industry. To paraphrase Michael Porter of the Harvard Business School and leading scholar in the field of strategy, improving the way you do business is desirable, but will not produce long-term benefits if it is something that your competitors can replicate (Porter, 1996). If competitors can easily copy your strategies, you will have to rethink them as you will not be about to maintain your advantage for long.

Consider concentration, a recognized strategy by which a company continues to better its product and broaden its market share. If the competition imitates this success by playing the same game, at best a company may gain a limited or momentary edge by developing a new product or powerful advertisement. Porter would say that this is achieving greater operational effectiveness, not strategy (Porter, 1996). The difference comes when a company can successfully differentiate itself in a way that is difficult or impossible for competitors to imitate. Differentiation is a form of playing a different game—a game which ideally only your company is positioned to win.

For example, TOMS Shoes founder Blake Mycoskie has created a unique business model that's a win for the company, its customers, and the hundreds of thousands of impoverished children in Argentina, Africa, Ethiopia, and the United States who receive a free pair of shoes for every pair purchased (Cook, 2009). There is nothing particularly special or unique about selling shoes, or the design of the TOMS model. Consumers have hundreds, if not thousands, of choices when it comes to casual, affordable footwear. But Mycoskie's differentiation strategy of introducing a social message of "doing good" into his business has resulted in a recognizable and profitable brand.

Gary Hamel and C. K. Prahalad, who formulated the "core competencies" business model, made a

similar point when they said that firms should not be too concerned about competing with their current competitors. Focusing on the actions of competitors puts a company in the position of simply making attempts to "catch up," by which time the industry leaders would have lengthened their lead again. Instead, they suggest that companies should prepare to compete in a future market, one that only they know about and for which, therefore, they would have the greatest lead time preparing to serve. When a company comes up with the right products to serve that market, it will, by definition, be the leader and have all others scrambling to follow and catch up (Hamel & Prahalad, 1994). These are valuable points, but identifying such a market is no trivial feat. Preparing to compete in a future market requires an intimate knowledge of industry and market trends as well as what is changing in the general external environment. These are, in fact, the requisite elements for strategic thinking when it is done properly, all the time, year round.

Associated Press/Ric Francis

Trader Joe's stores differentiate themselves from other grocery stores by having fast turnaround; selective and privately labeled products; small, intimate environments; great customer service; and extraordinary value.

One clear example of successful differentiation is the grocery store chain Trader Joe's. The chain began as a small group of stores based in Southern California and by 2011 grew to become a nationwide chain with 365 stores and an estimated $8.5 billion in revenue (Supermarket News, n.d.). Joe Coulombe, the chain's founder, quickly realized that he could not compete against traditional convenience stores such as 7-Eleven or well-known grocery store chains like Safeway. In order to be different, he drew on his love of traveling to France for food and wine, turning trips abroad into business trips to purchase for his stores. Today, Trader Joe's differentiates itself in five distinct ways:

- *Selective products*. Trader Joe's has a limited assortment of about 3,200 SKUs (stock-keeping units), a relatively small number for a grocery store. In contrast, a large supermarket would have on the order of 50,000 SKUs. The items turn over quickly.
- *Private-labeled unique products*. About 70% of the items in the stores are unusual items that were found on international buying trips and immediately repackaged with the Trader Joe's brand label. The stores do not stock commodities. Because most of the items are unique, customers can buy them only from Trader Joe's.
- *Small, intimate feel of each store*. The stores are kept intentionally small and very intimate. A Trader Joe's market is on average about 10,000 square feet. Safeway by comparison has an average store size of 55,000 square feet. If a store gets too crowded, another one is opened. Giving each location a neighborhood-store atmosphere that is not slick or chainlike turns it into a unique social experience for the customer. The Trader Joe's brand is, in fact, the store.

- *Fanatical attention to customers*. Everything Trader Joe's does centers on the customer. Its whole philosophy of buying and offering products is predicated on choosing those products that customers will and do buy. The products are selected and tested with the customer in mind. This forges a bond with its customers and gets them to come back time and time again.
- *Extraordinary value*. Trader Joe's buying target is a product with significant value, comprising taste, quality, private labeling, and price. Each product has to pass a number of tests in the tasting process. Trader Joe's thus ensures that the products taste good, meet rigorous standards of quality, and are priced competitively. That spells value from the customer's point of view. If Trader Joe's cannot find the best price for a product, the item is not carried in its stores (Abraham, 2002).

Trader Joe's is a model of what it means to play by your own rules and win. The chain's business model is unrivaled, with popular products and a trusted brand name. Customer loyalty is what sets Trader Joe's apart from competing grocers. After all, isn't one supermarket much like another? Finally, Trader Joe's selects the items it stocks and sells, whereas chain supermarkets all stock the same selection of brand-name products that manufacturers supply to all supermarkets. Because the grocery chains stock a common selection of name brands, manufacturers have bargaining power over them. That is why Trader Joe's is also more profitable.

Be Entrepreneurial

Those with an **entrepreneurial mindset** are "different" from everyone else. They see opportunity where others do not. They seem to have a special knack for discovering opportunities and thinking outside the box. Entrepreneurs are extremely mindful of value generation and tirelessly seek new ways to produce and deliver value. When something takes a long time to accomplish, they look for a faster way. If something keeps breaking down while using it, they look for a more reliable way. If something is too complex, they find a simpler solution.

The entrepreneur's ability to see opportunity depends first on a level of dissatisfaction with what exists today and a clear conception of the problem. After that, they generate ideas and possible solutions until arriving at a resolution to the problem, which they then develop into a product or service with commercial potential. In each instance, it is the customer's needs and level of perceived satisfaction that drive the changes pursued. The customer base is considered the number one concern, and the entrepreneur must constantly attempt to "walk in the customers' shoes" in order to determine what will fulfill their needs.

Dustin Moskovitz and Justin Rosenstein were two of the founders of Facebook. In their experiences at the growing giant, they frequently became frustrated with the difficulty of project management in an organization with layers of management, hundreds of employees, and a seemingly endless stream of innovations and new ideas. Realizing that their struggles to streamline collaborative work

and communication were common to many professionals, they eventually left Facebook to create *Asana*, a workplace-productivity-software company. Because Moskovitz and Rosenstein had walked in the customer's shoes, they had a great foundation for launching a business that would help other professionals solve common workplace-collaboration and project-management problems (Vance & MacMillan, 2011).

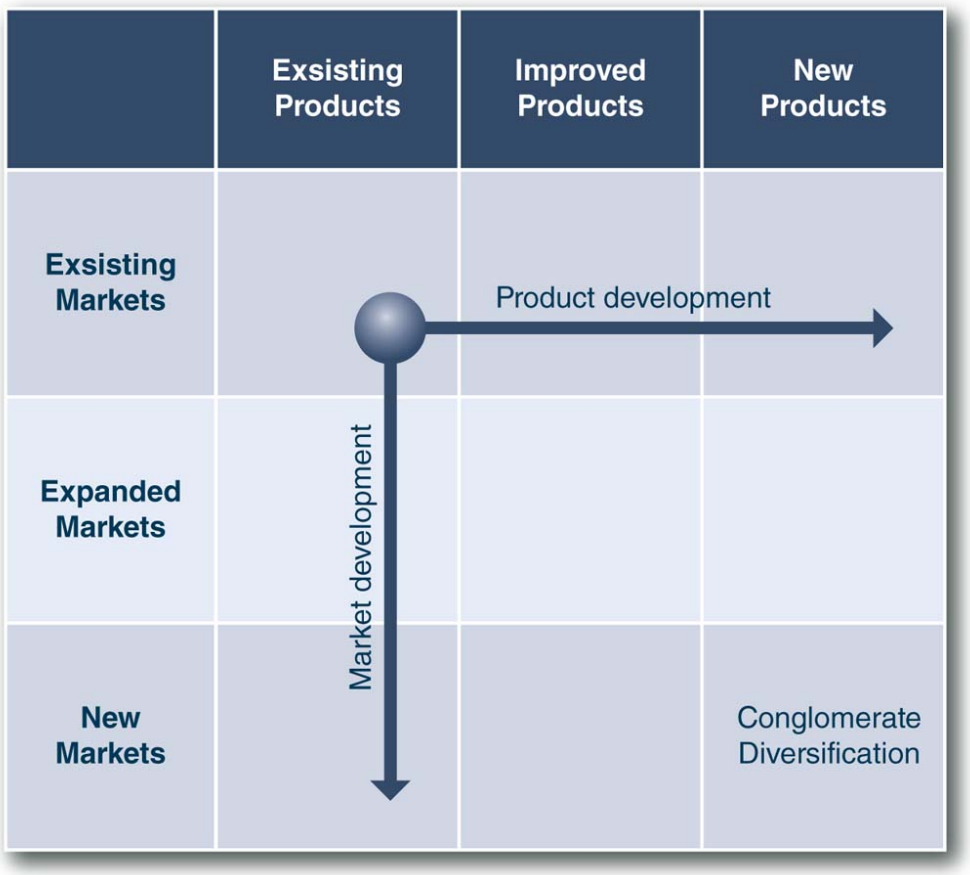
Associated Press/Rick Bowmer

Nike used a concentration strategy to develop a whole new line of athletic apparel in addition to its athletic shoes.

To be able to take advantage of strategic opportunities that they are missing, strategists, organizational leaders, and marketing professionals must learn to look at the world with entrepreneurial eyes and see it from the customer's perspective. Strategic thinking is concerned not simply with how to be different but with generating alternative possibilities of creating customer value that the organization can deliver.

Figure 3.1 shows a matrix of products and markets. All companies in business are, by definition, in the top-left cell, selling existing products or services to an existing market. The bottom-right cell—coming up with a new product for a new market—is not common because of the huge risk such a move entails. Its technical term is conglomerate diversification. Companies that must enter a brand new market with a brand new product should do so either through acquisition or one or more strategic alliances if they are to mitigate the high risk. When product- or market-development strategies are implemented, it is rare that only one of the components is affected. Improving the product is likely to expand the market, and expanding the market usually entails improving the product. Improving or modifying the product often attracts new customers, for example when a sedan is modified to be sportier or even into a convertible. Expanding a market usually involves modifying the product in some way. For instance, selling cars in England that are made in the United States or the European Community requires putting the steering wheel and driver controls on the right-hand side.

Figure 3.1: Concentration strategies



Stanley C. Abraham, Strategic Planning: A Practical Guide for Competitive Success, p. 32. Copyright © Emerald Group Publishing Limited. Reprinted by permission.

Find More Opportunities

In terms of improving the product or introducing a new one, where do ideas come from besides the customer? Several approaches might be helpful: a system for innovation, Abell's three-dimensional business-definition model, an experience-based opportunity-search method, structured brainstorming, and strategic frontiers.

System for Innovation

The system for innovation is most useful for coming up with new product ideas rather than changes to an existing product line. In its most basic form, employees are asked to submit ideas for new products to a new-product-development committee. Employees would be given guidelines and some incentive to propose projects and should always have their efforts acknowledged. They would be instructed to give just enough information to enable the committee to determine whether it should follow up on the idea or not. If the idea has merit, the contributor would be asked to provide more detailed information, such as market demand and likely customers, manufacturing process,

costs, additional development needed, and likely volume. If the committee then believes that the idea has market potential, it would decide to allocate resources to develop the proposal further, possibly to a prototype stage, along with detailed market and competitive analyses. This would continue until the product was approved for full-scale manufacturing and marketing. Under such a system, the committee would meet as often as there were projects to consider.

Abell's Three-Dimensional Business-Definition Model

Derek Abell (1980, pp. 29–30) proposed that the mission of a corporation is determined by three dimensions. These are (1) customer groups, or who the company serves; (2) customer needs; and (3) capabilities and technologies, or how the company will meet the customer needs. This analysis is known as Abell's three-dimensional business-definition model. Abell maintained that mission statements should contain all three elements. In addition to defining a company's mission statement, this model can also be very effective in searching for new opportunities.

The first step is to brainstorm different kinds of customers or customer groups that might use or buy the product. Then brainstorm different products that could be made using the company's skills, capabilities, and technologies. For example, a furniture company that makes the upholstery for all its furniture and whose business was declining, produced an idea in a brainstorming session to manufacture sails for boats—the same skills employed in making upholstery, but using different designs and different materials. Lastly, brainstorm other products your customers need or buy that you might provide.

With respect to this last dimension, consider *Reader's Digest* Association, publisher of Reader's Digest, the largest-circulation magazine in the world in 1992 (around 28 million readers). As famous and as popular as its magazine and brand were at the time, the real value to the company is the huge database of subscribers that it had (about 50 million households in the United States and an equal number spread across other countries). It has used that database to sell various products such as condensed books and other publications, videos, CDs, and so on. In 1992, 66.7% of its revenues and 91.8% of its operating profits came from selling products through mail order (its "database-distribution channel"), far higher percentages than its flagship magazine (Kopp and Lois Shufeldt, 1994). Using Abell's model, what other products could it send down this distribution channel (that would be amenable to mail order and that would appeal to its subscriber base)?

Remember that what you are doing when brainstorming is drawing up a *menu* of opportunities, not the final ones you are going to adopt. You might think of it as creating a wish list, without regard to how many items get on that list. Later, prune the list down to those that appear feasible and relevant to the company's business. While you will now have a much smaller number, you may still have too many to adopt. As a guideline, aim for 10 real opportunities, with 4–6 as a more typical

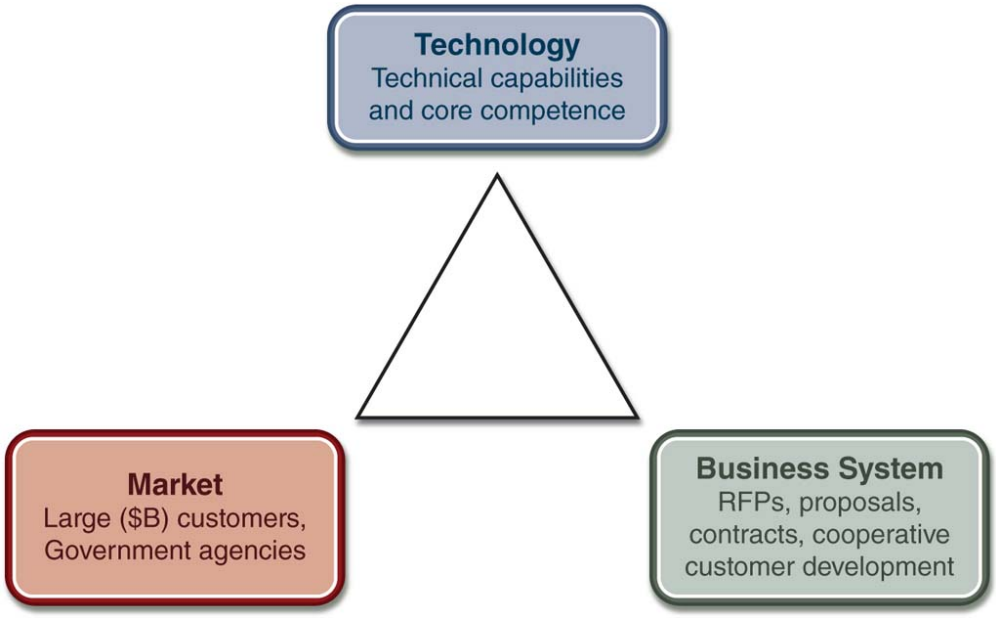
range. Investigating the feasibility of more than a handful of opportunities is prohibitively expensive for all but the largest companies. Most, if not all, of these will appear later as strategic issues to be evaluated as to whether it makes sense for the company to pursue them.

An Experience-Based Opportunity-Search Method

A few years ago a multidisciplinary team of students at California State Polytechnic University undertook a yearlong project to identify commercial opportunities for a large aerospace company in the Los Angeles area. The company had a system for innovation, which in the past three years or so had yielded over 80 ideas, of which only three had been pursued and implemented. All three had subsequently been sold to other companies, because the company did not consider them to be integral to their core business. In terms of ongoing products and revenue streams, the company was still searching for opportunities to pursue. Clearly, the company's system for innovation was not working. Furthermore, finding new opportunities took on particular urgency because the defense industry was in the midst of a long-term decline.

In explaining how it went about the process of seeking opportunities, the company showed the team a triangular diagram that was used to depict the company's strategic options (Figure 3.2). The points of the triangle each represented one of three variables, one or more of which could be adjusted to stimulate ideas for new business opportunities. These parameters defined the project, which was essentially to find a number of concrete opportunities the company could pursue.

Figure 3.2: Opportunity-search method



In simple terms, the options consisted of some combination of finding new markets, developing new technologies, and modifying the existing business systems. For example, the company could try to find new customers without changing either its technical capabilities or its business system. This constraint limited potential customers to large billion-dollar companies or the federal government. Another option would be to update its technical capabilities to develop products for existing markets while maintaining its present business systems. A third possibility would be to innovate with its business system, while keeping the others constant. At a deeper level of complexity the company could change any two sets of variables while keeping the third constant, or it could change all three at once. Clearly, the more variables that are changed simultaneously, the riskier the strategy. Initially, the team was asked to confine its search for opportunities to finding new customers while keeping the other two variables constant. Later, because that constraint was found to be too restrictive, it was relaxed to include acquiring a new technology or core capability if the opportunity in question was significantly large and worth pursuing, and even include changing its business system.

The actual method this team used was a combination inside-outside approach. The inside-out part involved first gaining an understanding of the company's products, technologies, capabilities, and business systems, and then trying to find new markets and applications that might fit the company. The outside-in part involved first looking at competitors, markets, industries, and application areas to find opportunities, and then comparing them against the company's technical capabilities and business process to see which were feasible. The project team came up with 28 ideas but quickly discarded half of them because of obvious deficiencies or mismatches with the company's capabilities. The remaining ideas were then pruned to seven candidates, from which the company selected four for further study. The team finally recommended three solid opportunities that met all criteria. The project showed that gearing up to find opportunities is time-consuming and costly and really should be done year round. In this way, a company will have time to act on those it finds that have real potential.

Opportunities are the lifeblood of any organization and one of the primary sources for key strategic issues for the company. Many strategic issues entail making choices between opportunities a company could pursue and, in fact, the key ones find their way into one strategic alternative or another. That is when the decision is made as to which opportunity or opportunities should be pursued, particularly in the typical case where the company cannot afford to pursue more than one at a time.

Structured Brainstorming

Thinking outside the box helps businesspeople seek solutions to problems in ways that are neither

mundane nor predictable. The following opportunity-seeking questions may serve to facilitate a structured brainstorming process to develop potential opportunities:

- *Are there other customers who might benefit from our product, even if the product is used differently?* Hughes Aircraft was a major aerospace and defense contractor that faced shrinking markets for its products when defense budgets began declining in the early 1990s. One of its divisions focused on selling and servicing satellites for government and industrial clients. To reduce its dependence on government contracts, it created a different business model directed at a consumer market. The technology that it had developed for the military and large corporate customers was repurposed to enable the beaming of television channels and movies off satellites to home-mounted satellite-dish receivers. By 2001, the division, now called DirecTV, accounted for 77% of Hughes' profits at the time (Tucker, 2001).
- *What other products could we produce for the same customers?* Tyson Foods provides a good example of a company finding new opportunities by expanding its product offerings to existing customers. In 1967, Tyson was doing very well, with $53 million in annual revenues from selling raw chickens, mainly to grocery stores in Arkansas and neighboring states. Growth options at the time were either to truck the chickens to more states or come up with new products. The first new product was a chicken patty for sandwiches. In due course, as a result of trying to figure out how to "do more with chicken" (Tyson's motto), it began offering chicken pieces, marinated chicken, frozen prepared-chicken dinners, chicken tenders, chicken nuggets, and ready-to-eat chicken "buffalo wings." Along with these product innovations, Tyson explored different distribution channels. Instead of selling chicken products only to food shoppers through grocery stores, it set out to reach consumers even when they went out to eat, and expanded its markets to include fast-food outlets, restaurants, airlines, and hospitals. In the early 1980s, it worked with McDonald's to add chicken to its menu. In the decade that followed as Chicken McNuggets became popular, Tyson experienced a 7-fold increase in revenues and 19-fold increase in earnings per share (EPS) (Tucker, 2001).

Associated Press/Paul Sakuma

Tyson Foods reached more customers by offering different kinds of chicken products.

- *What other types of products might we create, for any customers that have need of our expertise, technologies, and ability?* Matsushita Corporation is a conglomerate that produces products for many markets worldwide. At one point, it was faced with the maturing of its rice-cooker, toaster-oven, and food-processor product lines. Using technologies contained in each of them (computer-controlled heating from the rice cooker, heating devices from the toaster, and motors from food processors), it created a new consumer product, a bread machine, that produced a variety of breads reliably and simply every single time. The

product produced outstanding sales the first year it was introduced (Abraham & Knight, 2001). In contrast, Motorola, which had been producing amazing touch-screen cell phones in its labs in China for the Chinese market, failed to move that technology from China to the United States and other markets. Why? There was no innovation process, or standardized-pipeline mechanism that focused on bringing out a steady stream of innovative products (Nussbaum, 2008).

- *How might we reinvent our business model in order to gain a competitive advantage?* Thomas Weisel Partners Group was a leading force in taking dot-com-era firms public in the late 1990s. Weisel, for example, ushered many small start-ups under the Yahoo! umbrella. But when the dot-com bubble burst in 2000, he was forced to either reinvent the company or take up golf prematurely—probably on a public course. Like many other firms that survived the crash of the tech market, Weisel now focuses on easily profitable social-media and social-networking sites. Because these sites rely on relatively inexpensive technology, they tend to make money quickly. Similarly, Sandy Robertson, a technology-oriented private-equity banker, describes the critical business-model shift from "old" tech to social media: "Social media is the new frontier." Like those firms that survived the first bubble bust, these are aware that the social-media craze might not last forever, either, and remain dynamic and flexible in their models and practices (Craig, 2001). Apple provides another good example. While not the first to bring digital music to market, it simply took over that market when it launched the iPod. Apple's true innovation was making downloading music easy and convenient by adopting a business model that combined hardware, software, and service.
- *Looking to the future, can we predict which industries will have the highest growth?* This is a variant of the previous question and involves diversifying into a business in which the company has little experience or know-how. At first glance some people might say that pursuing such a strategy would be irresponsible and a recipe for disaster. There are, however, ways of entering a new business area intelligently and while minimizing the inherent risk of a diversification strategy. A company could always hire someone having a great amount of experience and know-how in the proposed industry to head up the effort. It could also acquire a company already in that business whose management had the necessary experience and expertise. Assuming that these steps could take care of the inherent initial risk, the issue here is identifying which industries are growing rapidly.

While finding opportunities for growth should always be a top priority for a company, there is an endless list of companies that have allowed themselves to become distracted from their main business, whether through an acquisition, integrating vertically backwards, diversifying, or searching for other opportunities. A company must continue to perform optimally at its core business while the search for new opportunities takes place simultaneously. When the current business stops growing, two things happen: pressure to maintain profits and the stock price leads to cost-cutting, including programs for new-product development, and the cash available for developing new sources of revenue dries up (Fisher, 2001). Putting a manager or small group permanently in charge of the opportunity-finding process will enable the company to keep its focus

on its present business, the growth of which must be maintained. Losing that focus can be fatal to a business (Reis, 1996).

Strategic Frontiers

In their book, *The Power of Strategy Innovation*, Robert Johnston and Douglas Bate propose that companies adopt a process called "strategy innovation" which is the term they use for strategic thinking (2003). One important concept put forth is exploring a **strategic frontier**, which they describe as anything a company might do in the future that it is not currently doing or that could be an extension of its current strategy. That might involve targeting a new market, entering another business, merging with another company, forming a strategic alliance, broadening the product line, adopting a new technology, and so on. The authors define strategic frontier as "that unexplored area of potential growth that lies between today's business and tomorrow's opportunities," (113). Table 3.1 presents some examples of strategic frontiers.

Their method advocates first getting top-management agreement or alignment as to which strategic frontier is to be explored, but this unnecessarily limits the person or group and runs the risk of the chosen frontier not being the correct one. It is better for the exploration to be open-ended and to *inform* it with information about how industries, competitors, and markets change.

Table 3.1: Some strategic frontiers

Company-Specific	Company-Generic	Marketplace
New product	Franchising	Artificial intelligence
New product category	Globalization	Biotechnology
New distribution channel	JIT manufacturing	Genomics
New manufacturing process	Mass customization	Internet
New positioning	Outsourcing	Nanotechnology
New sourcing strategy	Partnerships	Smart materials
New technology	Patent exploration	Wireless communications
	Services	Automation

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One of the best models for sustained growth that embodies some concepts discussed earlier comes from a book written by three partners at McKinsey & Company, a well-known global management-consulting firm. They call the model the "three horizons of growth":

- *Horizon 1* constitutes the company's core business and accounts for the lion's share of profits and cash flow. The Horizon 1 business must be successful for initiatives in Horizons 2 and 3 to be viable.
- *Horizon 2* comprises businesses or lines of business on the rise that could transform the company but not without considerable investment. They might be described as the emerging stars of the company. Though profits are still several years away, they show strong revenue growth and a growing customer base. They are entrepreneurial in nature and focus on increased revenues and market share. They could be extensions of the firm's current business or moves into new directions. Horizon 2 emphasizes building new streams of revenue for the firm that could in time become Horizon 1 businesses.
- *Horizon 3* businesses are options on future opportunities, but they are not simply ephemeral ideas. Rather, they are real activities and investments, however small, such as research projects, minority stakes, pilot projects, etc. These might never show a profit or conversely they could be successes that eventually end up as Horizon 1 businesses (Baghai, Coley, & White, 2000).

The key is to manage all three horizons concurrently. Putting off Horizon 2 or 3 businesses is tantamount to closing down the company's future. While these may be new terms for short-, medium-, and long-range projects, the principle is the same. To ensure long-term growth, the company has to "fill the pipeline" and then nurture Horizon 2 and 3 projects into Horizon 1 successes. A company's vision has to encompass all three horizons, not just Horizon 1. Using earlier constructs, this describes a formal opportunity-finding mechanism operating all the time, producing a "portfolio" of products or businesses with growth potential. These opportunities then have to be managed and brought into the mainstream of what the company does, its Horizon 1 businesses. Identifying and starting Horizon 3 businesses, for example, takes a very different entrepreneurial mindset and approach from managing the current core Horizon 1 business successfully. The difference is opportunity-finding and strategic thinking.

The new opportunity or fledgling business should be run as a separate enterprise, primarily because it might require a business model very different from the company's current one. Trying to create and implement a new business model while operating the existing one is difficult at best. Christensen proposed the concept of a disruptive strategy, that is, one that will disrupt the market but at the same time broaden the customer base and help the company grow. He cites the example of Teradyne, a company that made sophisticated integrated-circuit-testing equipment. In the mid-1990s, it sensed that competitors were about to introduce a cheaper, simpler version of the product that could test simple circuits at the low end of the market. Rather than wait, Teradyne

decided to beat them to it. Because creating such a product would also disrupt Teradyne's current product, it needed to be handled by an independent group within the company. By keeping very tight control on costs and a separate focus, the venture achieved $150 million in annual sales within 18 months of its release in 1998 (Christensen, Johnson, & Darrell, 2002).

Discussion Questions

1. If playing a "different game" makes so much sense strategically, why doesn't every company follow that advice?
2. Is it possible for established companies—even ones in mature industries—to think entrepreneurially?
3. Consider a company that had an "opportunity-finding" process it followed throughout the year. Presumably its opportunity "pipeline" would be full and it would constantly be deciding which ones to pursue, an enviable position to be in. What could go wrong with such a process? Why might it not produce envisioned results?
4. Might following a rigid process for identifying and analyzing opportunities stifle creativity? Doesn't creativity flourish better in a freewheeling environment? Discuss.
5. A company has, over time, succeeded in differentiating itself and raising its profits. What must it do to capture those benefits over an extended period? Can a differentiated edge erode? Discuss.

3.3 Finding Unique Market Spaces and Situational Monopolies

Section 1.6 introduced Kim and Mauborgne's concept of a blue ocean and why it made so much sense to look for one (Kim & Mauborgne, 2005). This section explains two related techniques that are central to strategic thinking: finding a blue ocean, and how to find a situational monopoly, a related concept proposed by Milind Lele of the University of Chicago Graduate School of Business (2005).

Value innovation is at the core of a blue-ocean strategy, which places as much emphasis on value as it does on innovation. Instead of having to make a trade-off between differentiation and cost, as most strategies require, value innovation seeks to pursue differentiation and low cost simultaneously, which is easier to do when you are in a market space with no competition.

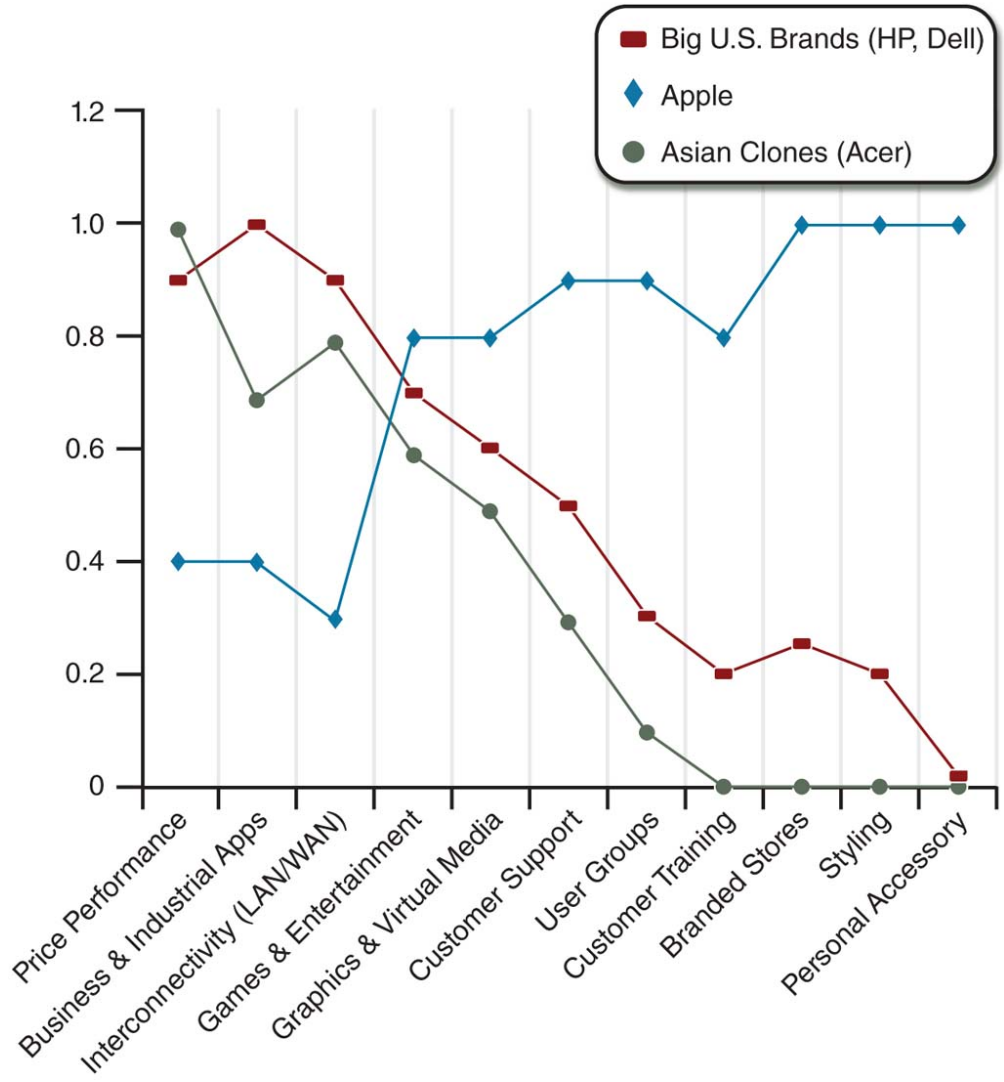
Kim and Mauborgne's two analytic techniques for beginning to think about how to find a blue ocean, namely the strategy canvas and the four-action framework, are summarized in the following sections.

The Strategy Canvas

The **strategy canvas** technique takes the form of a graphical two-dimensional representation. The x-axis comprises a list of the factors on which the industry currently competes, such as price, features, promotion, distribution, service, and so forth. The y-axis represents the offering level that buyers receive across all these competing factors.

When the offering levels of each competing factor, whether for an industry, a segment of it, or a company, are connected, the resulting plot or strategic profile is called a **value curve**. For a company, its value curve is a depiction of its relative performance across the key competitive factors of its industry. Figure 3.3 shows a depiction of the strategy canvas for the personal-computer industry.

Figure 3.3: The strategy canvas for the personal computer industry

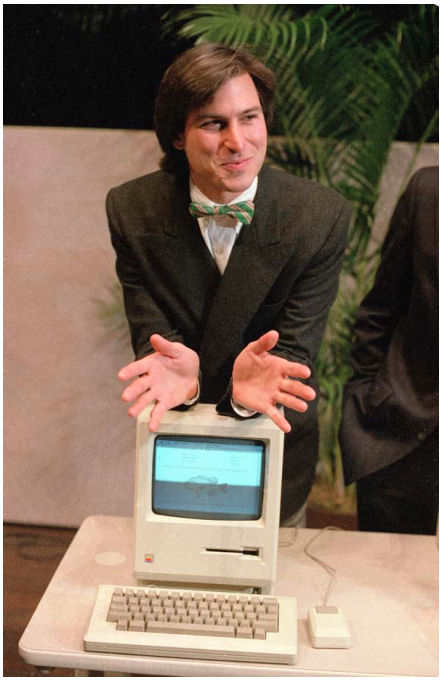


Value curves can depict performance of an industry or its segments. Creating value curves can be based on extant knowledge of an industry or company, or a melding of the opinions of a group. The fact that what results isn't as accurate as if done through extensive research doesn't matter. The important thing is to ask the right questions and focus on the right issues. Greater skill comes through more practice.

Value curves of segments and companies may or may not intersect. In parts where they overlap, a company is not differentiated on those competitive factors. Where the company's value curve is higher than the industry's, the company is clearly differentiated on those issues. In a situation where a company uses issues on which the industry doesn't even register such, as using unique competitive factors, the company can be said to have found a blue ocean.

From the founding of Apple Computer in 1976, Steve Jobs envisioned the PC as a personal-

information device. The Microsoft-Intel alliance, euphemistically called WinTel, appropriated this notion and made the PC business that of an industrial computer, sold in quantities to large corporations. By 2001, the PC market had degenerated into a "red ocean" of price/performance competition where ever-faster computers with ever-greater memory and storage were being offered at ever-decreasing prices.



Associated Press/Paul Sakuma

With Apple computers, Steve Jobs implemented a strategy that turned the personal computer into a personal accessory that the consumers could be identified with.

Jobs saw an opportunity to refocus the PC on people, not corporations. Jobs' vision of the PC was not so much a personal computer as it was a personal accessory, much like the automobile had become by the 1950s. He envisaged the computer as something that people would use as a tool while at the same time being something to which they attached their identity, much as they might a designer handbag. Jobs realized this vision by designing Apple's computer to be visually beautiful, so it became almost a fashion statement. In manufacturing Apple incorporated industry-leading screen technology and superior case materials such as titanium rather than the plastics used by competitors. Apple set the industry standard for customer service, and reintroduced the concept of branded retail stores. The Apple Stores are about brand building, not sales; for the first two or three years, Apple lost money on every computer sold in its stores. Apple deliberately raised prices of its products to cover the advanced visual appeal of its machines and the high level of customer support, aware such prices would reduce the price/performance metrics of its products.

Although there will always be a corporate industrial market for PCs, by 2008, with mobs of excited customers filling its branded retail stores, Apple had created a blue ocean marketplace where the other PC competitors were no longer relevant. By August 2010, Apple had become the most valuable technology stock in the world and then became the company with the biggest market capitalization in the world (Crum, n.d.).

The Four-Action Framework

A first attempt at plotting a company's value curve might disappoint if the curve is too similar to that of the industry. This means, of course, that the company is not at all or not sufficiently differentiated. The **four-action framework** is designed to stimulate thinking to find ways to differentiate the company and even ways of competing that have not been contemplated by the

industry, which is to say, a blue ocean.

Situational Monopoly

The conventional mental model of a monopoly is a company that accounts for 100% of sales in a given industry; that is the definition taught in every introductory economics course. Governments created the majority of such monopolies. In Britain, for example, in the past the state ran the railroads, telecommunications, airlines, health care, and other major industries. Most have since been privatized, except for the National Health System (Abraham, 1974).

Notwithstanding the traditional definition, a form of monopoly exists that most successful companies operate at different phases of their operation. Lele termed this a **situational monopoly** or **monopoly space**, and it exists because a company either creates or takes advantage of a situation to charge monopoly prices. It is "an ownable space for a useful period of time" and is natural, legal, and surprisingly common (2005, p. 25). Consider the high concessions prices at movie theaters and sports arenas. Vendors are able to charge inflated prices because the facilities allow only food and drink that was purchased there to be consumed on the premises. Similarly, consumers are forced to pay high prices for brand-name replacement-ink cartridges for printers if the warranty is not to be voided. In the personal-care-products business one can see this same situation with replacement-razor blades.

Companies can create a situational monopoly through innovative business practices. Dell was able to enjoy a 10-year monopoly when it was the only computer manufacturer selling made-to-order PCs for the corporate market. Enterprise Rent-A-Car grew to be the largest car-rental company in the United States because it is the only car-rental company that caters to people for local, nontravel-related needs such as renting a car when their own car is being serviced or repaired, and it will pick you up and drop you off at the end (Lele, 2005).

To discover where your company's next monopoly space might be, look for a pattern and a situation where customers want something that existing competitors can't or won't provide. In other words, look for an emerging need, incumbent inertia, and new capability. All three conditions must be present for a monopoly space to be opening up (Lele, 2005).

Because owning a monopoly space is legal and produces high profits, every company should want to look for one and hang on to it as long as possible. In fact, Lele says, a company's chief responsibility should be to find its next monopoly space. That should be the goal, and how to get there should be the strategy (2005).

Case Study

The Merger of Whole Foods and Wild Oats: Shattering the Situational Monopoly

In early 2007, the premium organic and natural-foods grocer Whole Foods proposed a purchase of competitor Wild Oats' 190 stores. Subsequently, the Federal Trade Commission challenged the deal, claiming that because Whole Foods and Wild Oats were the "only two nationwide operators of premium natural and organic supermarkets in the United States," the purchase would enable the creation of a monopoly in this market.

In his ruling against the FTC, United States District Judge Paul L. Friedman highlighted the ways in which contemporary market dynamics shatter monopolies. Essentially, although Whole Foods and Wild Oats were the only supermarkets dedicated to the sale of natural and organic products, Friedman pointed out that other national supermarket chains such as Wegmans, Safeway, Publix, Kroger, Supervalu (and subsequently, even Walmart) have invested heavily to compete in this market. Court documents even referred to statements made by Whole Foods that the chain had reduced prices in order to be competitive with some of these other mainstream supermarkets' natural and organic offerings.

Although Whole Foods and Wild Oats together at one point had a monopoly space on premium natural and organic groceries, other supermarkets had realigned their strategies to enter and compete in this market. "To put it colloquially," Friedman wrote, "this train has already left the station" (*Federal Trade Commission v. Whole Foods Market, Inc., and Wild Oats Markets, Inc.,* p. 37).

The Whole Foods/Wild Oats merger calls into question the staying power of monopolies and situational monopolies. The current economy, enabled by globalization, quick and flexible decision making (often facilitated by digital media), and the need to be adaptive and dynamic in business practices may extinguish these notions. What do you think?

Questions for Critical Thinking and Engagement

1. In our contemporary era of business and organizing, is it possible for a true monopoly to develop? If yes, in what industries and why? If no, why not? What about a situational monopoly?
2. What factors made it desirable and easier for mainstream supermarkets to enter the domain of Whole Foods/Wild Oats than in the past?
3. Can the creation of a situational monopoly be strategic, or a byproduct of

circumstances?
4. Do organizations with situational monopolies spend resources to keep others out of the market? Why or why not?
5. Identify another example of a once situational monopoly that now splits market share or that has exited the market entirely. Describe the circumstances either in writing or during class discussion, as directed by your instructor.

Discussion Questions

1. Which concept is more useful, in your opinion, in trying to find a unique market space with no competitors—the strategy canvas and four-action framework or a situational monopoly? Give reasons for your answer.
2. Do you think there are differences between the benefits of a highly differentiated strategy and being in a monopoly space? If so, what are they? If not, why not?
3. "Monopoly" still has an unfortunate and illegal connotation, yet owning a monopoly space is perfectly legal, highly profitable, and quite common. If you had to come up with another name for it, what would it be?
4. Can you use the four-action framework without a comprehensive knowledge of the industry in which your company is competing?
5. Must one use the strategy-canvas tool together with the four-action framework, or can they yield benefits when used alone? Discuss.

3.4 Creating Future Scenarios

The consequences of any decision made today play out in the future. Likewise, the product of every decision made during the strategic-planning process, including the strategy itself, happens in the future. It is important then that strategists and key organizational managers should feel comfortable in thinking about the future, because that is where they are going to live and work, implement plans and achieve results, and take the company to where it is going.

Some managers are not comfortable thinking about or dealing with the future, adopting an attitude that it is beyond their purview and is instead the burden of the executives. Many view it as "beyond their control." They feel that nothing they can do can change the inexorable momentum that carries us into the future. That is a fatalistic attitude.

One cannot change other people or their behavior, but one can control how one responds to other people and what one does oneself. Most of all, it is a deep-down belief that what you do does make a difference and can affect how things turn out in the future. This is called a **normative attitude**. People with a normative attitude do not extrapolate everything. While certain industries that are stable for a number of years lend themselves to short-term extrapolation, others are more volatile or unstable and are likely to be discontinuous; the future will be unlike the past.

How does thinking about the future relate to strategic thinking? First, any kind of strategic thinking is going to be set in the future, so learning some ways of forecasting or anticipating the future can serve you very well. Secondly, trying to do strategic thinking with a fatalistic or naïve attitude about the future will adversely affect the results achieved. Instead, a normative attitude asks, of all possible futures, what can be done to bring about a desired future. Finally, being comfortable about the future means being comfortable with ambiguity, uncertainty, incompleteness, and subjectivity. This is easier said than done. For example, most accountants, used to dealing only with historical information, find dealing with the future very difficult. In fact, they have resisted auditing forecast information for public companies for years, unwilling to take responsibility because of the uncertainty (Abraham, 1978).

Futures Research

Methods of looking at or analyzing the future are called **futures-research methods**. One of the most relevant methods that would enhance strategic thinking is **scenario planning**. Despite the fact that scenario planning requires weeks to months of time, training, and expertise, companies often benefit greatly from the shared learning process as well as from the end result. Such planning

can serve to position and hone employee skills as well as change set thinking habits.

Doug Randall (2009), managing partner of Monitor 360 and a partner at the strategic-consulting firm Monitor, believes that the future should be explored in order to understand more fully options that might be considered today. He offers the five following recommendations:

- Create scenarios that are plausible, not necessarily probable.
- Determine what it would take to be successful in each scenario; give your creativity free rein.
- Assess current capabilities and be painfully realistic.
- Identify gaps between current capabilities and what it would take to be successful in each scenario. Be honest in your analysis.
- Make choices considering all your options.

Belinda Images/SuperStock

Futures-research methods are a way to analyze the future, enhancing strategic thinking through scenario planning and future mapping.

Scenario Planning

Scenarios are detailed descriptions that attempt to predict or project the way that something might happen in the future. Engaging in scenario planning fosters preparedness; it allows managers to imagine a range of potential futures and get ready for them before they occur, should they occur. Further, it allows enough time for a management team to consider what the company might do for each scenario should it materialize (Fahey, 2003).

Scenario planning begins with issues deemed critical to the future of the company and about which sufficient information is unavailable to determine how the issue will turn out. For example, a critical issue for the automobile industry in the United States might be energy prices, or more specifically gasoline prices. For the housing, construction, and lumber industry, as well as homebuyers, the critical issue is interest rates, a principal driver and inhibitor of demand. A critical issue for the movie-theater industry and its suppliers today is digital technology. In what form and when will digital-transmission and -projection systems be introduced; and what will persuade movie theaters to invest in and switch to that technology? Some economists, business leaders, scientists, and geopolitical strategists are convinced that water is the new oil; that is, water is rapidly becoming the "blue gold" and is in short supply. Does this represent an opportunity or a threat? (Ebb without Flow, 2009). It is around such critical issues that two to three scenarios are devised, so that they may be compared and contrasted. Potential strategies are not only possible responses to a scenario

about the future but also to what different players are likely to face and do within each scenario. These actions in turn may influence which strategy may be more appropriate (Wells, 1998).

To begin forming scenarios, one needs to collect information about key forces impinging on that critical issue and driving forces in the macro environment. This is very research-intensive and could cover markets, new technology, political factors, economic trends, demographic changes, and so on. Peter Schwartz says that in this phase one should look for major trends and trend breaks. Next, the key factors and driving forces are ranked on the basis of two criteria: (1) how important they are in determining the success or outcome of the critical issue identified in the beginning, and (2) the degree of uncertainty surrounding them. One is looking for the most important and the most uncertain. The factors that are most important and most uncertain will now form the axes along which the eventual scenarios will differ. The purpose is to end up with just a few scenarios whose distinctions make a real difference to decision makers. These sets of issues must be reshaped and regrouped in such a way that a logic for each one emerges and a story (the scenario) can be told. As Stuart Wells says, "The essence of this process is writing stories about the future as if we were viewing the past" (Wells, 1998).

Perhaps a benefit of equal importance to the value of the insights gained from developing scenarios is the learning that takes place during the process. This learning should be integrated into the strategic-thinking and decision-making processes. Liam Fahey (2003) suggests the following scenario-learning principles:

- Scenarios are only a means to an end and should primarily inform decision makers and influence decision making.
- Scenarios should be used to carefully form questions about the present and the future and guide how they might be answered.
- Each step must aim to identify, challenge, and refine manager mindsets and expertise, rather than attempt to perfect scenario content.
- Scenarios bring to light information that enables managers to track and monitor how the future is developing. In this way, the learning process is ongoing.

Discussion Questions

1. Because there is more than one possible future, we don't know how things are going to turn out; that is, we don't have a crystal ball. Explain why going through scenario planning might provide more useful information than just getting the latest forecast from the *Wall St. Journal* or *New York Times*.
2. In your opinion, is the cost of engaging an expert on scenario planning and all the management time involved worth the benefit? Give reasons for your answer, particularly with respect to what benefits might be produced.

3. Scenario planning is a complex, time-consuming activity. Can you think of another way to generate similar results at much less cost?
4. Can strategic thinking be done without some form of scenario planning?
5. Are scenario planning and other similar methods only possible for large corporations? Can you think of any way in which small companies might access those benefits?

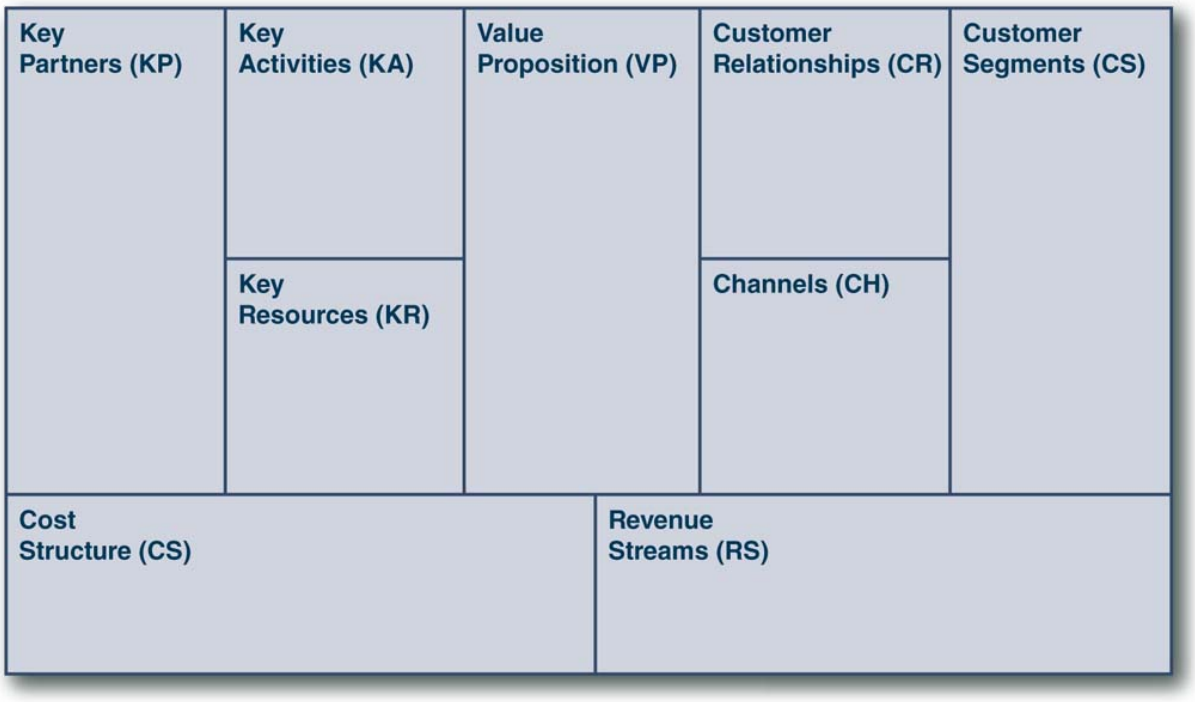
3.5 Finding a Better Business Model

Section 1.8 introduced the concept of a business model as having elements that describe how a company goes about attracting more customers, making money, and growing. A more detailed model of the firm can be more helpful when doing strategic thinking concerning how to improve one's business model or find a better one.

This model, shown as a "business-model canvas" in Figure 3.4, has nine building blocks (Osterwalder & Pigneur, 2010):

- Key partnerships (KP)—the outsourced activities and resources acquired outside the company
- Key activities (KA)—the activities required to deliver the above elements
- Value propositions (VP)—why do customers buy from the company?
- Customer relationships (CR)—the relationships established and maintained with each customer segment
- Customer segments (CS)—which ones does the company serve?
- Key resources (KR)—assets required to offer and deliver the above elements
- Channels (CH)—communication, distribution, and sales channels used
- Cost structure (CS)—the cost structure of the elements of the business model
- Revenue streams (RS)—revenue streams that result from the value propositions successfully offered to customers

Figure 3.4: The business model canvas



Source: Alexander Osterwalder and Yves Pigneur, Business Model Generation: A Handbook for Visionaries, Game Changers, p. 44.
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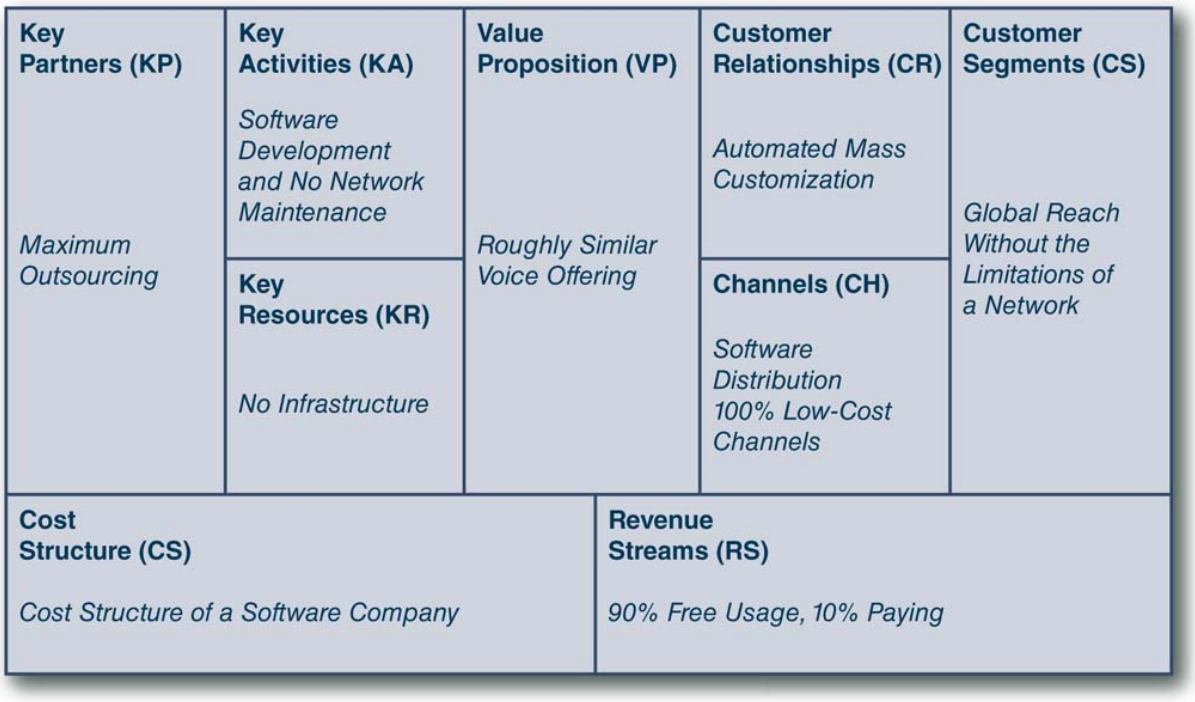
Using the same business-model canvas, Figure 3.5 shows how Skype's business model disrupted the telecommunications providers. In its first five years, Skype had over 400 million users, experienced over 100 billion free calls, and in 2008, generated $550 million in U.S. revenues.

As a strategic-thinking exercise, first use the business-model canvas to describe the company's current business model (keep entries very brief). Regard each of the nine elements as a source for business-model innovation; elements can be changed one at a time or several at a time.

As you can see, it requires a great deal of creativity and strategic thinking to come up with feasible and purposeful ways of improving the business model to help the company be more successful.

Figure 3.5: Skype vs. Telco



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Summary

In Chapter 1, you learned that strategic planning is a process designed to choose the best strategy a company can follow, as well as decide on its purpose, vision, and objectives. Because strategic thinking, done well, produces potential strategies to follow and suggestions for innovating its business model, it is an indispensable prerequisite to doing strategic planning.

This chapter explored the complex concept of strategic thinking—what it is and how to do it. Strategic thinking includes the constant search for a better strategy, a better business model, and a "blue ocean," situational monopoly, or uncontested market space. It also includes developing alternative futures or scenarios to reduce future risk and guide strategic choice.

Searching for a better strategy involves playing a different game—not being like your competitors, being entrepreneurial (looking at things from a customer's perspective and looking for opportunities all the time), and finding more opportunities. The chapter presents a number of useful techniques for coming up with opportunities, like Abell's three-dimensional business-definition model, structured brainstorming, and identifying strategic frontiers.

Finding a "blue ocean" is made easier using two related techniques—the strategy canvas and the four-action framework, both created by the authors of the book *Blue Ocean Strategy*. Finding a situational monopoly is easier and, ironically, upends our mental model of a monopoly (illegal in the United States, although the situational monopolies described here are quite legal).

The chapter presents the most useful technique for developing alternative futures—scenario planning. To derive the full benefits, a company wanting to use it should get expert consultation because of its complexity.

The chapter concludes with the business-model canvas, a tool comprising nine building blocks that facilitates improving the company's business model either incrementally (changing any one of the building blocks at a time) or more radically (changing two or more building blocks simultaneously). Such moves have to be analyzed for feasibility and effect before being considered seriously.

Concept Check

Key Terms

entrepreneurial mindset Seeing opportunities everywhere.

four-action framework A tool designed to stimulate thinking to find ways to differentiate the company and of competing that have not so far been contemplated by the industry (a blue ocean).

futures-research methods Techniques for looking at or analyzing the future.

normative attitude A deep-down belief that what you do does make a difference and can affect how things turn out in the future.

monopoly space or situational monopoly Exists because a company either created or took advantage of a situation to charge monopoly prices. It is an ownable space for a useful period of time.

scenario planning A planning tool designed to create a small number of plausible futures constructed around critical issues for the company about which sufficient information is unavailable to determine how the issue will turn out.

strategic frontier Essentially anything a company might do in the future that it is not currently doing or that could be considered an extension of its current strategy.

strategy canvas A graphical two-dimensional representation: The x-axis comprises a list of the factors the industry currently competes on, such as price, features, promotion, distribution, service, etc., and the y-axis represents the offering level that buyers receive across all these competing factors.

thinking outside the box A metaphor for thinking outside of the normal mental models that influence the way we view the world.

value curve A depiction of a company's relative performance (its strategic profile) across the key competitive factors of its industry on a strategy canvas.

value innovation Seeks to pursue strategies of differentiation and low-cost leadership simultaneously.

Chapter 4

External Environmental Analysis

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Learning Objectives

By the time you have completed this chapter, you should be able to do the following:

- Conduct an industry and competitive analysis and understand why it is important.
- Conduct a market analysis and understand why it is important.
- Scan the general environment for any changes or trends that might favor or adversely affect the company.

An analysis of the external environment covers the industry or segment in which the company competes, its competitors, markets, and other relevant environmental trends and changes. The

purpose is to understand how the environment relevant to the company is changing and might change in the future --in this sense, "relevant" means anything the company might affect or could be affected by. Without such an understanding, doing strategic planning becomes much more difficult.

4.1 Industry and Competitive Analysis

An industry analysis is the study of a firm's industry and the forces that might be causing it to change. It involves using a number of standard but indispensable tools, including Porter's five-forces model, industry attractiveness (part of the GE Matrix), driving forces, critical-success factor analysis, and strategic groups, all discussed in this chapter. Because the ways in which an industry changes can dramatically affect the decisions a company makes, an industry analysis has become a key element in strategic planning.

The word *industry* in "industry analysis" can mean a segment of a larger industry or the industry itself. If a company manufactures disk drives for personal computers, for example, it could say that it competes in the disk-drive industry for purposes of doing a strategic analysis, even though that is really a segment of the computer industry. What we are really analyzing is the arena in which the company competes.

Ryan McVay/Photodisc/Thinkstock

Assembling a group of knowledgeable people can be very helpful when performing an industry analysis.

One thing to keep in mind when conducting an industry analysis is to write down what is true for the industry, not for the company under analysis. Sometimes industry data are easy to obtain because they are regularly published or because trade groups or consulting firms keep tabs on industry statistics. However, many industries are not tracked by any group, or they consist largely of privately held firms. This makes it difficult to get industry data and complete an industry analysis.

To minimize errors when using inadequate data or relying on one person's estimates, it is advisable to assemble a group of people to share perspectives and use shared estimates in the analysis. If the group is fairly knowledgeable about the industry, the perceptions gathered about the industry will be more useful and make the understanding more complete. Group members who have differing estimates and opinions will be forced to explain their views and, in the process, either convince others they are correct or be persuaded to change their own views or estimates. In this way, a shared perspective leads to greater understanding.

Doing an Industry Analysis

The purpose of doing an industry analysis is to answer the following kinds of questions:

- What are the dominant economic characteristics of the industry?
- In what ways is the industry changing, and why?
- Do buyers and/or suppliers have greater bargaining power?
- How steep are entry barriers?
- Is the industry concentrated or fragmented?
- What must one do well in order to succeed in this industry?
- How appealing is the industry?

Dominant Economic Characteristics of an Industry

Economic characteristics can vary by industry but generally are applicable throughout business and include the following:

- *Industry size*—total dollar sales of all firms in the industry.
- *Industry growth rate*—percentage increase or decrease over the previous year.
- *Scope of competitive rivalry*—local, regional, national, international.
- *Number of competitors*—if known.
- *Stage in the industry's lifecycle:*
    - emerging—must be a brand-new industry with total industry sales less than 5%.
    - growth—total industry sales growing at over 5% per year.
    - shakeout—a transitional period between growth and maturity where some competitors fail, others are acquired, and the total number of competitors shrinks.
    - mature—total industry sales of between 0–5%
    - declining—the growth rate must be negative for several years in a row.
- *The customers or buyers*—Who are they? Where are they? How many are there?
- *Degree of vertical integration*—How many companies in the industry are vertically integrated forward? How many are vertically integrated backward? How many are vertically integrated in both directions?
- *Rate of technological innovation*—How dependent is the industry on technological innovation? How much innovation is taking place?
- *Product characteristics*—Are the products commodity-like or differentiated? This determines to a large extent the bargaining power the industry has with respect to buyers. Are the products high- or low-tech?
- *Economies of scale*—for example in purchasing, production, shipping, distribution, or advertising.
- *Capacity utilization*—Is capacity utilization in the industry high or low? How sensitive are variations in capacity utilization to profits? In commodity-like industries, profits are very sensitive to capacity utilization.
- *Industry profitability*—If profitability in the industry is not high, what are some causes? Commodity-like industries are low-profit, while those with differentiated companies command higher profits.

Forces Driving Industry Change

To understand how an industry is changing, identify the **driving forces** causing those changes. The following are examples of driving forces:

- Changes in the industry growth rate
- Changes in who buys the product and how customers use it
- Product or marketing innovations
- Changes in technology
- Exit or entry of major firms
- Circulation of technical knowledge
- Increasing global scope of the industry
- Changes in cost and efficiency, for example, in process innovations
- Emerging buyer preferences for differentiation
- Changes in governmental or economic policy
- Deregulation or increasing regulation of an industry
- Changes in societal attitudes, concerns, and lifestyles
- Reductions or increases in uncertainty and business risk
- Likelihood that this and one or more other industries will merge or converge

It is one thing to ascertain that an industry has been and is changing, but quite another to gauge the way it will change in the future. That is, however, the challenge managers must face. If one can come to understand how an industry is changing and what is causing it to change, the chances are good that future changes can be predicted and possibly anticipated. In many industries today, rapidly advancing technology is changing everything about the industry—the product itself, how it is made, how it is distributed, and how it is used. The examples provided of driving forces may provide a starting point for an examination of a particular industry and how it may be changing. Of course, it is important to keep in mind that every industry is unique and may have driving forces other than those listed here.

Bargaining Power

What exactly is **bargaining power**? In simple terms, it comes down to who dictates the terms such as price, delivery, quality, and the like in a negotiation. Consider the example of someone trying to sell a used car. There is a certain "Blue Book" price for a car of a certain model, age, mileage, condition, and options. If the make and model is in high demand, the car at issue has low mileage, and is in good condition, then the price will be higher. It is possible that several potential buyers may actually bid up the price. The seller in that situation may demand full payment in cash and other conditions, and will probably have those demands met. In this case, the seller has bargaining power and will end up making a favorable deal. On the other hand, if the seller is desperate to sell the car, or it is not in very good condition, perhaps needing major repairs, and the seller has to incur

costs to advertise extensively, he may have to accept the first offer that comes along, even at some fraction of his asking price. In this case, the buyer would have all the bargaining power and the seller none.

Sometimes both buyers and suppliers have bargaining power. In that situation it is likely that the industry in question has low profitability, the product is viewed as a commodity, rivalry among competitors is fierce, and innovation is relatively low. On the other hand, if companies in the industry have more bargaining power than both buyers and suppliers, the chances are that it is profitable, the products and competitors are differentiated and have strong brands, competition is controlled as it is in monopolistic competition, and innovation may be fairly rapid.

For another example of bargaining power, consider the unfortunate predicament of a California tool manufacturer. About 90% of the company's production was going to one customer. Profit margin was understandably low. One day the customer demanded a price reduction of 10% and delivery in small quantities at frequent intervals, thus forcing the tool manufacturer to carry even more inventory and increase its costs. If the company had not been so dependent on this one customer, it might have refused to supply it but it could not. Instead, it got squeezed. It's not difficult to tell who had the bargaining power here.

This example is true and, while unfortunate, illustrates how shortsighted companies can be. The customer in this case did not appear to care that it might drive one of its principal suppliers out of business. Walmart is another example of a company that, because of its size and influence with its customers, retains the bargaining power when negotiating with its suppliers. It, too, appears to run many of its suppliers into the ground in its drive for ever-lower costs.

In contrast, Toyota and other companies practice Kaizen, a system in which independent suppliers sign long-term agreements with the manufacturer, practically collocate with the manufacturer, earn fair profits, and are given help and training to supply products and parts at the desired level of quality and delivery.

If a company has many suppliers all competing for the contract to supply it, the company has bargaining power. If it has to purchase a component, however, and only one company can supply it, that supplier will have bargaining power. One strategy that suppliers have for retaining bargaining power is to raise the switching costs of the buyer, that is, make it so expensive for a buyer to switch to a competing supplier that it will not do so. Consider a supplier that provides its customer's procurement staff with computer terminals that are tied in with its own system, enabling the customer to order at any time, track the status of delivery of any order, and so on. The service could be so convenient, and the purchasing company's people so well trained and comfortable in using

the ordering system, that it might not change suppliers even if a lower-cost competitor came along.

Porter's Five-Forces Model

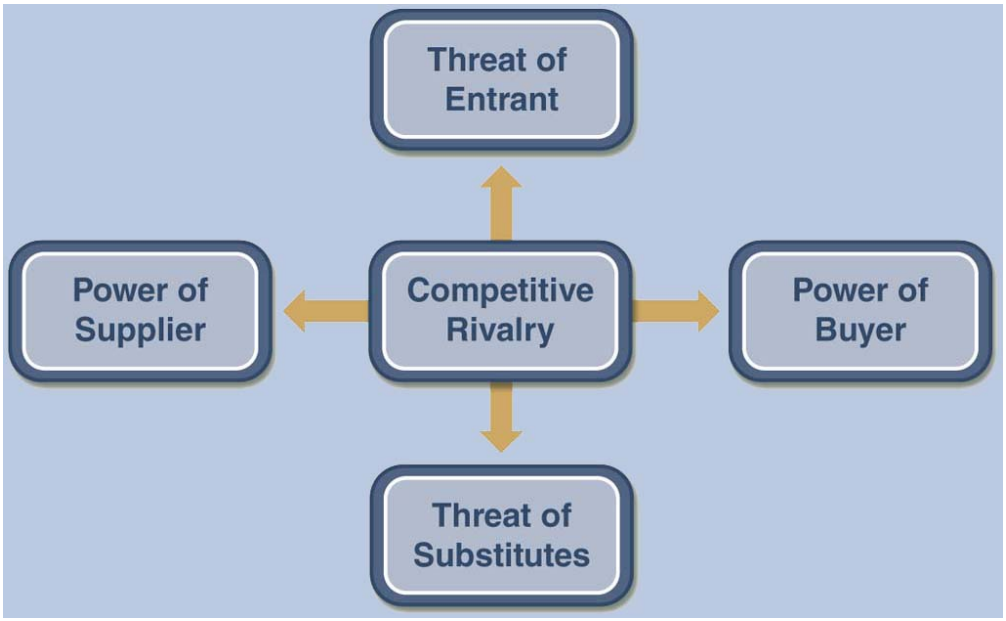
In 1980, Michael E. Porter of the Harvard Business School developed what is probably the most influential tool for assessing the structure and competitive threats of an industry. Porter proposed a framework that in a given industry, five forces determine the degree of competitiveness in that industry. Competitiveness, in turn establishes the attractiveness or profitability of the industry. This model can be used by organizations considering a wide range of strategic plans, including entry into the industry and beyond. The five forces described by Porter are

- Rivalry among existing competitors
- Bargaining power of buyers
- Bargaining power of suppliers
- Threat of new entrants
- Threat of substitutes

Figure 4.1 depicts **Porter's five-forces model** in diagrammatic form. The five main boxes in the shape of a cross constitute the actual model. The four "analysis" boxes in each corner add meaning to the model and enhance the industry analysis.

In the model, the terms *buyers* and *suppliers* are self-evident; these are the customers of the industry and the firms that supply the raw materials, respectively. Rivals are all of the companies presently competing in the industry. New entrants are firms not currently engaged in the industry but which could potentially compete in the future. For example, British supermarket chain Tesco PLC entered the U.S. grocery industry in 2007 under the brand Fresh and Easy, with an aggressive growth plan, concentrating primarily on the Southwest states. Although Tesco did not open Fresh and Easy locations in all U.S. markets, or even in all Southwestern communities, existing grocers were wise to be aware of the Fresh and Easy threat.

Figure 4.1: Porter's five-forces model



Source: Adapted from Alexander Osterwalder and Yves Pigneur, Business Model Generation: A Handbook for Visionaries, Game Changers, p. 99.Copyright © 2010 John Wiley & Sons. Reprinted with permission.

Substitutes are products in other industries that have the potential to draw customers away and are, in effect, also competitors. The concept of substitutes is sometimes hard to grasp; accordingly, the following example may help. The founder of a for-profit theater company in a moderately sized California town believed he had no competition as there was no other theater company in the town. Yet when his season tickets went on sale in the fall, they did not sell out. In fact, far from selling out, many tickets remained unsold all season long. He remained puzzled by this until someone asked him what a person in the town could do with $20 on a Friday or Saturday night. Well, he replied, that person could go to the movies, out to dinner, watch TV, go for a walk, go to a ballgame, go shopping, or visit with friends, among many other options. It turned out that "going to the theater" ranked quite low on this list, accounting for the dearth of ticket sales. This impressed on the theater owner that his real competition came from substitutes.

To perform an industry analysis for a particular company using Porter's model, one would begin by listing the company name as well as those of its principal competitors in the Rivals box. Next, write a description of the buyers and suppliers of the industry (not the company under study) in the respective boxes. Be careful not to list distributors or retail channels as buyers, even though they may purchase the products for resale. Porter intended that buyers for companies that make frames for glasses be listed as people, not optometrists. The names of any firms that could possibly enter the industry are entered in the New Entrants box. If no potential new entrants can be identified, the box should be

marked "unknown." Finally any substitutes to what the industry produces are written in the box so labeled.

Once the five boxes have been filled in on the model, then write a brief assessment of the intensity of rivalry (low, medium, or high, and why), bargaining power of buyers and suppliers (low, medium, or high, and why), entry barriers (low, medium, or high, and what they are), and threat of substitutes (low, medium, or high, and why) in each of the corner analysis boxes.

Porter's model provides a clear, straightforward way to assess the nature of competition in any industry. Users should take care not to be misled by the seemingly simplistic nature of this tool. Strategic thinkers must be thorough and wide-ranging in their thinking when analyzing each element within the context of their business, industry, and environment. As the theater owner's case illustrates, shortsighted or narrow thinking may lead to an inaccurate assessment of the elements and potentially negative implications for profit, public relations, employee morale, and more.

Barriers to Entry

High **entry barriers** keep potential entrants out of an industry. This is a good thing for a company that is already in the industry, but a bad thing for a company trying to enter the industry. Barriers to entry could take any of several forms. An industry that requires a significant capital investment to enter has a high barrier to entry, particularly to smaller firms. Another type of barrier is the need for expertise in a certain technology or manufacturing process, a core competence, or proprietary technology, which could cost a lot or take a long time to develop. Electronics and biotechnology industries have this barrier. An established brand name and customer loyalty, both of which take time to develop, may also provide a deterrent to would-be entrants. When an industry includes competitors with significant market share and market power or competitors with low costs that realize significant economies of scale, prospective entrants would probably view this as a barrier.

What if the potential entrant is a much larger corporation with more than adequate financial resources and possibly also a strong brand identity in a related market? The results of this assessment might turn out quite differently. The issue is to try to imagine (a) who the likely potential entrant might be; (b) why it might want to enter this industry now; and (c) make as best an assessment as you can. What is perceived by one firm to be a high barrier to entry may not present a deterrent to another.

Also, in some industries it may be easy to enter the industry but difficult to compete effectively on a national or global scale once having entered. For example, in the donut industry, anyone can open a single donut shop that serves local customers ("easy to enter"). Yet such an entrant would unlikely compete with the large national chains like Dunkin Donuts, Winchell's, and Krispy Kreme, and so would not present a threat at all ("hard to compete with").

Industry Concentration

Inga Ivanova/iStock/Thinkstock

Beauty salons are an example of a fragmented industry.

A **concentrated industry** is one in which a few firms in the industry account for a large portion of total industry sales. Examples are commercial aircraft manufacturing, in which only two firms compete (Boeing and Airbus), or the business of auditing public companies in the United States, in which 96% of the work is shared among the "Big Four" certified public accounting (CPA) firms. Even six to eight firms, accounting for upwards of 40% of an industry's sales, would qualify to be called concentrated.

A **fragmented industry** is one in which no one firm has more than a fraction of a percent in market share. Examples are beauty salons and the auditing of privately held businesses. Bookstores and fast-food restaurants used to be fragmented industries, but now are fairly concentrated due to franchising and the emergence of dominant chains.

For a company in a fragmented industry, it is difficult to increase market share unless you clone or standardize the business and duplicate or franchise it (Porter, 1982). This is what some fast-food companies did and what enabled them to become global giants such as McDonald's, KFC, Burger King, and so on.

Critical Success Factors

When a potential company is assessing an industry, it often needs to identify the industry's **critical success factors (CSFs)**. Think of them as constituting the rules of the industry. Just as every sport has its own set of unique rules, there is no way that one can "play" in an industry, let alone dominate it, without knowing and playing by those rules. CSFs attach to an industry, not to a company, and every industry has a different set. Ideally, a firm should be able to identify six to eight CSFs. One way is to come up with a much larger number first and then edit them down to those that are really essential to succeeding in its particular industry.

The value of identifying the industry's critical success factors becomes evident when they are used to compare a company with its key competitors. A CSF analysis allows a company to compare itself with its principal competitors using CSFs as the dimensions to do so (Table 4.1).

After choosing six appropriate CSFs for the industry, the example company was rated along the dimensions of the listed CSFs on a scale of 0–10, 10 being highest. The same was done for each competitor in the table.

Table 4.1: Critical-success-factor analysis

Critical-Success Factor	Company	Competitor A	Competitor B	Competitor C	Competitor D
Strength of brand	10	8	9	8	10
Distribution channels	6	10	9	8	7
New-product development	8	5	10	7	8
Financial strength	9	6	10	8	9
Customer service	8	7	8	9	5
Low costs	5	6	5	6	9
Totals	**46**	**39**	**51**	**46**	**48**

In the example shown, the company under analysis rated a total of 46 out of a possible 60. Comparing the scores gives a rough idea of how the company "stacks up" against its competitors, as well as how each of the key competitors stacks up against the others. To the extent that your ratings of a company and those of its competitors are accurate or realistic, the analysis provides useful information regarding whether or not the company has competitive advantages or vulnerabilities and which competitors are most dangerous.

Looking across the rows, the table reveals where there may be a competitive advantage or competitive vulnerability. In this example, the company's strong brand may constitute a competitive advantage. Competitor A may have one in its extensive distribution system, and Competitor B one in its ability to generate new products rapidly. Any rating of 5 in the table would signify a competitive

vulnerability, something that should be addressed in that company's short-term plans (like the company's and Competitor B's costs).

Looking down the columns, the analysis identifies which competitors are more dangerous than others. In the table, judging from the totals at the bottom, the company lies in the middle of the pack, with Competitors B and D to be more feared than the other two competitors. Competitive analysis includes how the company might react to attacks, especially from strong competitors (Coyne & Horn, 2009).

Industry Attractiveness

Can one measure industry "attractiveness," and is it important? The answers to these questions are yes and yes, but the measurement is highly subjective and the result is more useful in some situations than others. Industry attractiveness is based on of a number of attributes or characteristics. To discover them, imagine what an ideal industry would look like. It would, for example, have a huge market (potential customer base), be growing rapidly, be hugely profitable, have few competitors, be unregulated, have high entry barriers, and not need technological expertise. This would yield the following initial list of factors for an industry-attractiveness analysis:

- Size of the potential market
- Industry growth rate
- Intensity of competition
- Degree of regulation
- Entry barriers
- Degree of technological innovation

These factors, of course, constitute an incomplete list; they may be changed or amplified. Notice also that the factors are stated in a neutral way: "size of the potential market," not "large market."

To perform an industry-attractiveness analysis, first assign a weight to each of these factors as a percentage according to their perceived importance. Next rate each factor from the point of view of the company doing the analysis on a scale of 0–1.0. Finally, multiply the weight by the rating for each factor. Be careful in two instances: (a) If degree of competition is high, the rating should be low because it makes the industry less attractive, and (b) if degree of regulation is low, the rating should be high as it makes the industry more attractive. Remember that the rating should be high for any factor that makes the industry more attractive, and low if the opposite. Add up the products to yield a percentage figure.

Table 4.2 below shows an **industry-attractive matrix**, which is a weighted technique based on a number of factors to determine how attractive an industry is. The **industry-attractiveness (I.A.)**

index of 75.6 shows this to be an attractive industry, attractive enough to stay in it and invest in improving the company's position. When such an analysis yields a result of less than 50%, then the company might well ask the fateful question, "Should we continue to be in this industry, or should we exit?"

Table 4.2: Industry-attractiveness matrix

Factor	Weight	Rating	Product
Industry growth rate	24	0.8	19.2
Profitability	20	0.7	14.0
Size of potential market	18	1.0	18.0
Intensity of competition	16	0.3	4.8
Entry barriers	12	0.8	9.6
Degree of regulation	10	1.0	10.0
Totals	**100**	**I.A. Index**	**75.6**

Strategic-Group Map

In industries that contain disparate competitors, a **strategic-group map** is a useful technique to cluster and identify strategically similar competitors. Competitors can show differences—and similarities—to each other on various factors (Porter, 1982). Those that are similar to each other belong to the same strategic group; the more distant one strategic group is from another reflects the extent to which they are dissimilar and therefore, not direct competitors.

Daniel Acker/Bloomberg via Getty Images

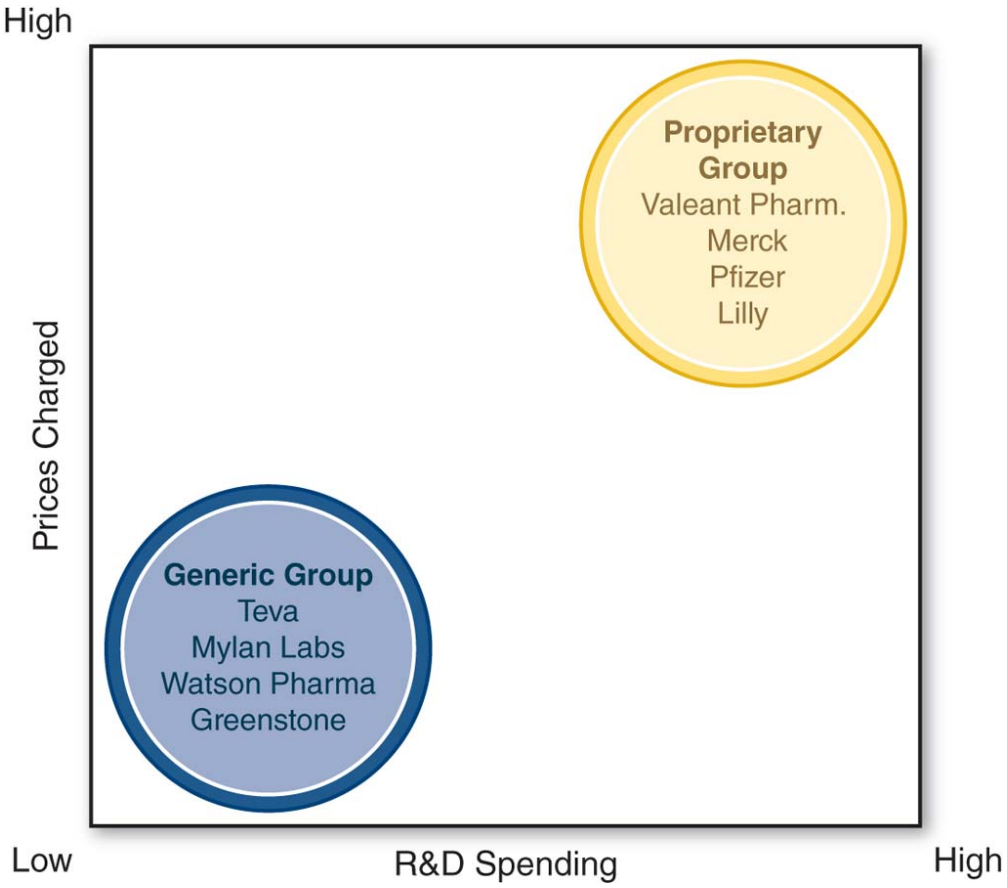
Budweiser is in the same strategic group as Miller Brewing company, but in a different group than microbrewers.

An industry often consists of a small number of distinct strategic groups. A strategic-group map is a two-dimensional representation of an industry's strategic groups. To create one, choose two strategic dimensions that are not correlated with each other, as are price and quality, and that have the capacity to separate the competitors in the industry. For example, if all companies in the industry have broad product lines, choosing this

dimension as one of the axes will not work—all the competitors would be bunched up at one end. On the other hand, positioning might be a useful dimension to use if there are some companies at the high end, some at the midlevel, and some at the low end of the industry. Other than the two guidelines given previously, there is no rule for choosing strategic dimensions that would serve as axes for the strategic-group map. The dimensions chosen as axes for a strategic-group map should embody strategic variables, not performance. Try several and see which two separate the competitors or rivals into clusters on the map. When you have several clusters that make sense and can articulate the strategy of each cluster, you have a useful strategic-group map. Naturally, using the technique presupposes a good working knowledge of competitors in a particular industry.

Figures 4.2 and 4.3 show examples of strategic-group maps. Figure 4.2 is a simple strategic-group map that represents the pharmaceutical industry. Figure 4.3 shows a slightly more complex strategic-group map of selected retail chains. The figures display different strategic dimensions in use and underscore the fact that companies in the same strategic group compete more intensely with each other, while competition between distant groups is virtually nonexistent.

Figure 4.2: Simple strategic-group map of the pharmaceutical industry



Source: Charles W. L. Hill and Gareth R. Jones, Strategic Management: An Integrated Approach, 10th ed., p. 96.
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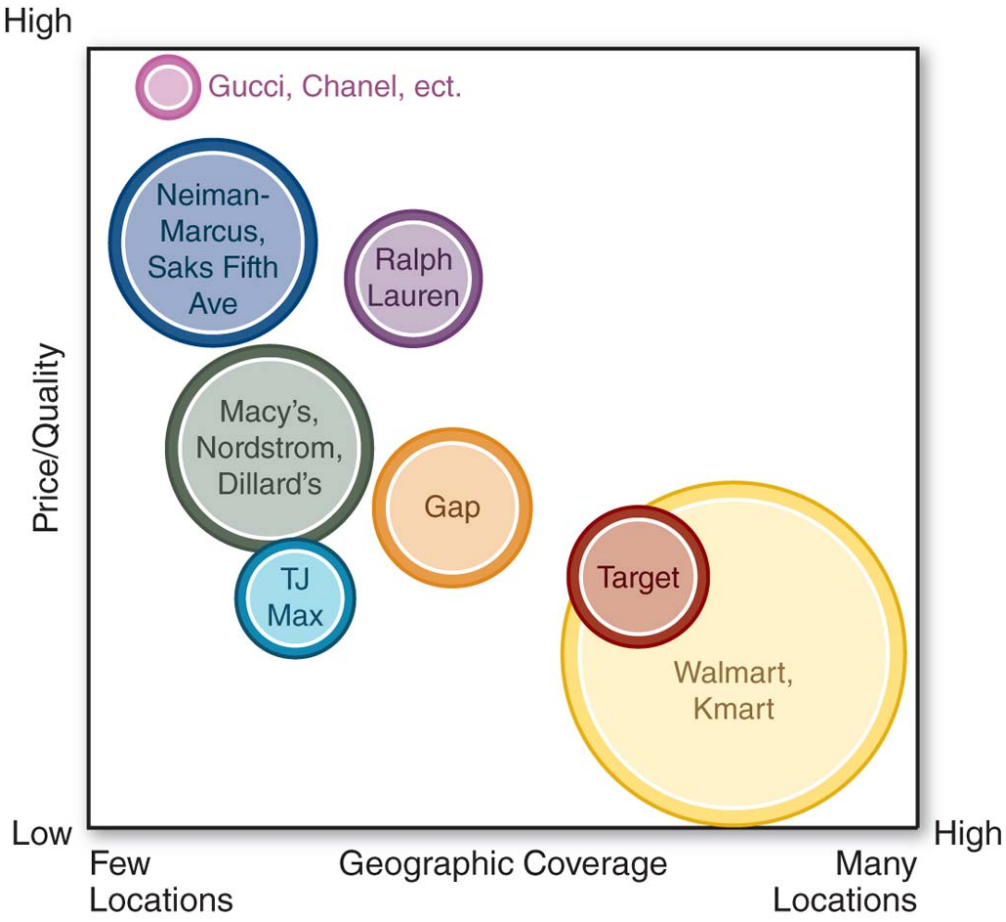
Figure 4.3: Strategic-group map of selected retail chains



Source: Adapted from Arthur A. Thompson, Jr., John E. Gamble, and A. J Strickland III, Strategy: Core Concepts, Analytical Tools, Readings, p. 68. *Copyright © 2004 Irwin McGraw-Hill. Reprinted with permission.*

What can be learned from a strategic-group map? First, the companies in a particular strategic group are strategically similar and constitute the group's key competitors. Those in a nearby group form the next tier of competitors. In all likelihood, companies in a distant strategic group are not really competitors although they are in the same industry. For example, in the U.S. beer industry, Anheuser Busch competes with Miller Brewing in the same strategic group, but not with the many microbrewers and some of the imported high-end beers, which are in distant strategic groups. In another example, this time in the hospitality industry, Days Inn (low end) does not compete with Ritz Carlton (high end) because they are strategically dissimilar and in different strategic groups;

their markets are quite different.

Zefa/SuperStock

It is imperative to know as much about your competitors as possible.

Secondly, the implications of Porter's five-forces model are different for different strategic groups. Entry barriers vary among the groups, as does bargaining power with suppliers and customers, the threat of substitutes, and the intensity of intra-group rivalry. Thus, it could be more desirable to be in one strategic group than another (there could be more opportunities and fewer threats) (Hill & Jones, 2001). For example, in retailing, a recession would adversely affect high-end department stores but actually increase demand for discounters and mass merchandisers. Because of such differences, it may be worthwhile for a company to move consciously from one strategic group to another. The ease of doing so depends on the size of mobility barriers between the groups (factors that inhibit both entry into and exit from a group). For example, in Figure 4.2, Greenstone is a generic pharmaceutical company that competes with others in its strategic group; it would find it very difficult to move into the proprietary strategic group with companies like Valeant Pharmaceutical and Merck. This is because Greenstone lacks the necessary R&D skills and resources that would take time and a great deal of capital to acquire.

Thirdly, one could discover some unserved demand in an area of a strategic-group map not occupied by any strategic group. In creating a strategic-group map of the automobile industry, using pricing and safety as the two strategic dimensions, a group of business students found that no company was offering a low-priced, high-safety automobile. Such a car might appeal to parents with teenagers and possibly older drivers (Harrison, 2003).

Finally, it is possible for a company to belong to more than one strategic group. In the hospitality industry, Hilton Hotels and Marriott compete in both the high end and affordable ends, through the lower-rate Hampton Inns and Courtyards by Marriott, respectively. In this illustration, each company, rather than surmount mobility barriers by moving to another strategic group, has penetrated another strategic group through internal diversification and acquisition.

Competitive Analysis

Strategy began as a military concept. Before going into battle, and during the battle itself, generals would try to find out everything they could about the enemy: their strength in numbers, their weaponry, supplies, communications capability, precise locations, intents, and strategies. To go into

a battle with no information about the enemy would be to put an army at considerable risk and its chances of success at virtually zero. It is only with good intelligence about the enemy—their movements, resources, and strategies—that a general or leader can plan strategy and deploy resources to win the battle or achieve a military objective.

The same imperative exists in business today. In virtually every business, companies must be aware of and know how to deal with their competitors. The first step is to ask, "How much do I know about my competitors?" One should know—or try to obtain—at least the following information about one's competitors:

- *Market share*—Many industries have publications that track these data, but companies will occasionally have to determine a competitor's market, or industry, share on their own.
- *Geographic scope*—Are your competitors local, regional, national, or international/global competitors?
- *Diversification*—Are your competitors conglomerates with a portfolio of businesses in unrelated industries, companies with many related businesses, companies with many strategic alliances, or companies in only one business?
- *Vertical integration*—The degree to which competitors are vertically integrated, especially backwards along the supply chain, may give them cost and competitive advantages that can be difficult to overcome.
- *Competitive advantage*—Do your competitors possess a competitive advantage? What is it? How large is it? How have they sustained it?
- *Core competence*—What are the core competences that underlie your competitors' strategies?
- *Strategic intent*—How are your competitors trying to position themselves in the industry? Are they aggressively trying to overtake rivals on their way to market dominance, or are they more concerned with defending their ranking and maintaining market share?
- *Strategy*—What strategies are your competitors following? In most cases, they can be inferred from other information known about the companies and what they are actually doing. Have the strategies been working, or are they about to be changed? Are mergers among key competitors likely? Are any of them looking to be acquired? If in a high-tech industry, what is their investment in R&D as a percent of sales?
- *Resources and capabilities*—How strong financially and technologically are each of your competitors? How flexible are they to adapting to the changing environment? How well managed? How fast do they bring new products to market? Do they have innovative cultures and a record of innovation? Which one just got a new CEO?

Trying to get this kind of information about key competitors also reveals how much or how little a company knows about them.

Discussion Questions

1. What additional information might an industry analysis provide that simply monitoring a company's competitors does not? After all, isn't the industry just an aggregate of all competitors?
2. Porter's five-forces model is a useful tool to analyze the competitive forces and structural characteristics of an industry. But isn't this, at best, a snapshot at a point in time? How could one get a more dynamic perspective?
3. Suppose a company has very little bargaining power with suppliers; in fact, its industry also is plagued with weak bargaining power. What are some ways of gaining more bargaining power?
4. What might be a method for identifying an industry's driving forces other than simply brainstorming?
5. Can a company be more profitable in a concentrated industry (not one of the industry leaders) or a fragmented one? Give your reasons either way.
6. The industry-attractiveness matrix is a highly subjective exercise. So what are the benefits of doing one despite the subjectivity?
7. A strategic-group map groups together strategically similar companies in an industry on a two-dimensional space. Yet, movement from one strategic group to another could experience mobility or entry barriers, different competitors, and significant investment. Does that make each strategic group an industry segment? Explain.
8. Once an industry's dominant economic characteristics and driving forces have been identified and Porter's five-forces analysis has been performed, how can the rules of the game for this industry and the critical success factors be discerned? Explain the steps this would take.
9. A critical-success-factor analysis can be very useful to a company in analyzing how it stacks up to its competitors. How might you tell if the numbers used in that analysis are realistic? Is there another kind of analysis you could do that would also yield good comparative data with your competitors?

4.2 Market Analysis

We now turn to an examination of a company's customers, which could be companies in another industry, like the auto industry, or individual consumers. A **market analysis** is an umbrella term covering the collection and analysis of data and information about a company's customers, which could be companies in another industry or individuals (consumers). While it is relatively straightforward to get information about a customer industry, getting useful information about consumers is more difficult. The demographic or socioeconomic groups of some consumers make them harder to analyze and understand. It is important to keep in mind the target market and degree of market penetration, changing customer needs, and distribution channels and pricing, as discussed in the following sections.

Target Market and Market Penetration

First consider the **target market**. For example, if banks buy your product, your market is banks. But are you targeting all banks worldwide (which is the overall market), only the large banks, only neighborhood banks, only banks with over $2.0 billion in deposits or over 500 branches, or middle-market banks nationally? Very few companies can target the entire population of their markets although there are exceptions such as Coca-Cola, Microsoft, and so forth. So a company needs to define its target market—what is it, how large is it, and how fast is it growing? It also must decide who is the **served market**, or that portion of the target market that is either currently served by the company or its current focus.

Another factor to establish is the degree of **market penetration**. How far have all the companies in the industry penetrated the market? In other words, what proportion of the target market has bought a product/service from your industry? If the answer is 60%, the market is said to be 60% penetrated, leaving 40% that is unserved or underserved among them. When a market is 100% penetrated, it is considered saturated.

The degree of penetration is, however, more complex than the illustration discussed here. For example, not all of the target market may purchase a product from the industry for various reasons— they cannot afford to, don't need to, and the like. So the target market is often reduced to what is called a served market made up of viable customers who could buy the product or service. Also, though rare, it is possible for markets to be more than 100% penetrated, as when households own more than one TV or car.

Changing Customer Needs

What are customers' current needs? From what is known of a company's customers and industry, can their needs be inferred? And can the degree to which such needs are currently satisfied be assessed? When we speak of "needs," we mean benefits or what we now term value propositions. Companies that are constantly listening to their customers will know their needs and how they are changing (Ulwick & Bettencourt, 2008).

What will the customer need in the future? This is a chicken-and-egg situation. New products and services often affect customers and satisfy needs they never knew they had, and sometimes unsatisfied needs are the spark that causes new products and services to be introduced. Try to address the question "How are customers' needs changing?" The extent to which this proves difficult to answer indicates whether the company is in touch with its customers or doesn't know enough about them.

Distribution Channels and Pricing

The next stage of the market analysis is a consideration of the company's **distribution channels**. This means learning how the industry's products reach the market. One must find out whether the industry typically supplies products to wholesalers, distributors or retail outlets. In some industries it is standard practice to employ salespersons to make direct sales calls, while in other industries, catalogs and direct mail are the norm. The extent to which the Internet is used as a distribution channel is increasingly important. Note any differences between the distribution channels the company uses and those used by the industry in general. Another way of looking at this is to ask how customers buy the products. What is the decision process they go through before they decide to buy (Court, Elzinga, Mulder, & Vetvik, 2009)?

An analysis of the distribution channels would not be complete without determining the size of channel markups. That is, for each stage in the distribution channel, what price is paid by the wholesaler, the distributor, the retailer, and what price is paid by the final customer? If volume discounts are expected and offered at each stage, the quantities at which these become applicable and the amount of the discount are key data points. While a company's profits depend on the price it receives for the product, its competitiveness depends on what the customer will pay.

One also needs to establish the degree to which customers are price-sensitive in the target market. **Price sensitivity** is critical with respect to how prices are set and changed and, indeed, which distribution channels are used. The following example of the law firm illustrates the importance of knowing how price-sensitive customers are (see Case Study: Price Sensitivity and a Law Firm).

Any current trends in customer behavior are vital to an understanding of how the target market may be changing. Are customers buying differently? Are they becoming more demanding? Any

other aspect of industry customers not covered elsewhere should be covered here. For example, increasingly, customers of brick-and-mortar bookstores like Barnes & Noble are actually buying their books on Amazon.com.

If a company does business in several markets, such as different countries, this type of detailed market analysis should be completed for each of those markets. Companies that target business customers (B2B) would do well to analyze the value chain of their major customers in order to discover which part of it is unserved and take advantage of the opportunity to move in to fill that need (Crain & Abraham, 2008).

Case Study

Price Sensitivity and a Law Firm

A patent-law firm once held a retreat to go through a strategic-planning process. During the process, the partners in attendance maintained that it was the best firm of its kind in the large metropolitan region it served. A review of its finances revealed that its billings (i.e., sales) were flat, a situation that prompted the retreat in the first place. During the competitive-analysis phase, the firm acknowledged that it had about five principal competitors, all of which charged higher hourly rates than it did. Reluctantly, the partners finally admitted that hourly rates generally correlated with reputation; the higher the fee charged, the better the firm was perceived to be. Worse, it turned out that several of the firm's partners were offering discounted rates to clients for fear that they would not even get their business. They expressed the fear that if they raised their rates, the firm would suffer a drastic decline in business. They felt hamstrung. The answer, of course, was that they were either serving the wrong kinds of clients, or they were not as good as they claimed to be. The latter conclusion was perhaps closer to the truth given their discounting behavior. Certainly, the market was not nearly as price-sensitive as they thought it was, as evidenced by the fees its competitors were charging—and getting.

Discussion Questions

1. Why is defining your target market so difficult? If you agree, suggest how it can be made easier and yield accurate results at the same time.
2. Is distinguishing between "market," "target market," and "served market" useful? In what ways?

3. How might you discover that your target market would welcome opportunities to co-create value with your company?
4. What surveys would you take of your customers that would help guide what products to produce and how to persuade them to buy?
5. If you were designing a customer-relationship-management (CRM) system, what elements would you include and why?
6. Why is it that customers of highly differentiated companies are not that price-sensitive?
7. Customers buy products because, for the most part, the products satisfy their needs. (The exceptions are impulse buys.) Are "needs" and the "benefits" they receive from using the product the same thing?
8. List the benefits you might experience from buying each of the following:
   A movie ticket
   A logo t-shirt
   A novel
   A car
   An iPod
   A vacation cruise
   Flowers for your spouse or date

4.3 Environmental-Trend Analysis

The almost dizzying pace of change going on in technology and business requires companies to plan differently than they have in the past. In order to keep pace with the rapidly changing environment, companies should divide the environment into categories or manageable pieces and, in each category, try to articulate (a) what is changing and in which direction, and (b) with what impact on the company. If the change has no relevance for the company or for what it might do in the future, then it deserves to be ignored. If a trend cannot be clearly defined in terms of direction (for example, something getting larger or smaller, increasing or decreasing), then it should be omitted. Saying, for example, that the "economy is in a recession" is not useful as a trend.

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Analyzing environmental trends involves looking at what is changing and its potential impact on the company.

Environmental scanning is a common name given to identifying and analyzing trends that are external to the business (Fahey & Narayanan, 1986). People who engage in it have found that it is easy to get caught up in what they are discovering. Before they know it, they are collecting information for its own sake. Most companies cannot afford that luxury. Again, the search should be confined to trends that are relevant to the company, specifically any trend that affects the company or that may affect it in the future.

The currency of the collected data in environmental scanning is a valuable resource. Typically, one can find information on trends using historical data. However, the milieu in which strategic planning takes place, or the period during which the consequences of present decisions play out, is the future. A trend noticed during the 2004–2009 time frame, for example, may have limited value or even none at all in the 2012–2017 time frame. However, if the trend can be extrapolated or extended in a justifiable manner to the future time frame in question, then it becomes valuable. Nevertheless, firms must be cautious, because some trends are discontinuous, meaning that behavior in the future is different from behavior in the past. While simple extrapolations can be performed by almost anyone, more complex forecasting, such as technological forecasting, must be done by an expert and may require consulting assistance. For such projects, the organization must have the requisite time and resources. The tradeoff between spending resources to do something properly and taking educated guesses when such resources are unavailable is something that the company will have to consider carefully.

In many cases, rather than doing the forecasting internally, a firm can find estimated or projected

data on trends to fit its future time frame. For example, demographic data taken from census data contain projections for at least 30 years into the future. Whenever using such projections, it is important to know how reliable the source is and, preferably, how the projections were derived. The more critical such data are to the company, the more care the company should exercise to ensure that reliable data and analyses are being used. Economic forecasts, for example, are particularly difficult to verify as to quality; economists can be wrong even for short-term forecasts.

Finally, the environmental scan should cover a geographic scope that matches the arena in which the company competes. For example, a distribution company operating and competing only in New England should pay more attention to what is happening in the New England economy rather than what may be happening nationally. Figure 4.4, for instance, shows the strategic group for the wholesale lumber industry. A large multinational company would have to extend its scan into every country in which it does business (buying, manufacturing, or selling) as well as include exchange rates between those countries and how events or trends in one of the countries might affect any of the others. The international environment is far more complex than dealing with just one country. For example, managers in each country are typically asked to complete an environmental analysis in their own country along with other analyses and projections required for strategic planning.

Figure 4.4: Strategic group map of the wholesale lumber industry

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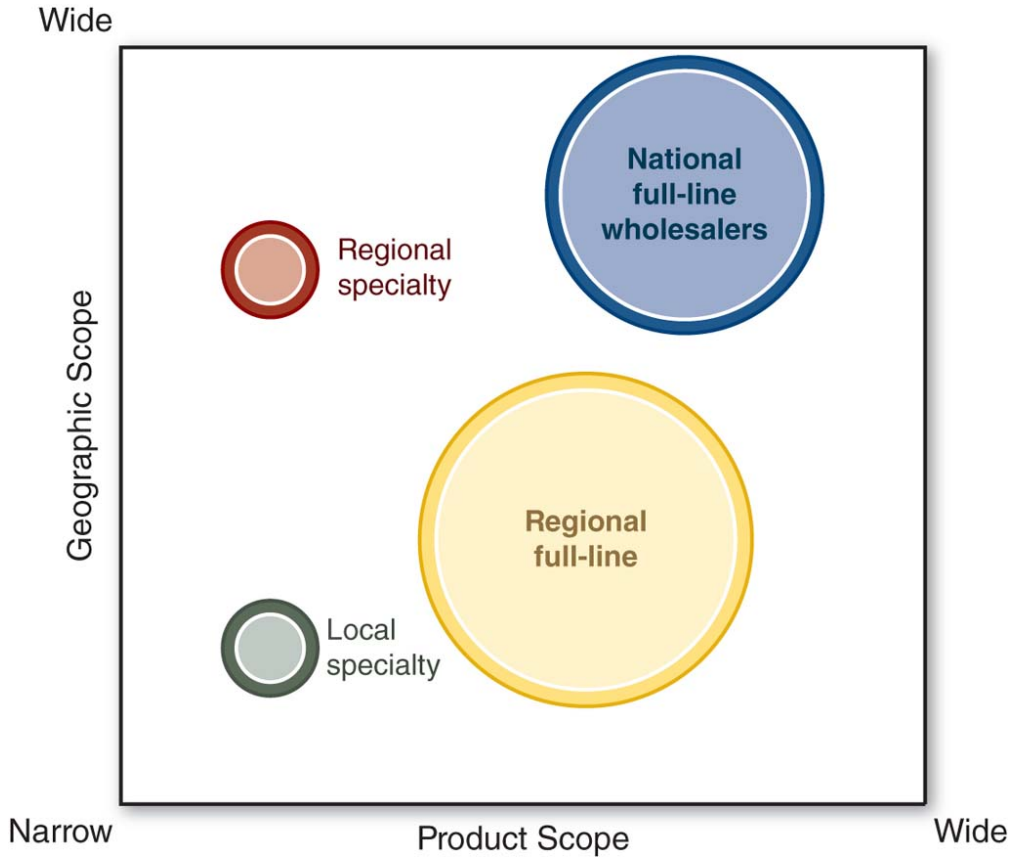

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When conducting an environmental-trend analysis, there are seven common categories that the company should consider: economic, regulatory/legislative, political, demographic, sociocultural, attitude/lifestyle, and technological. No one category is more important than another per se, though certain categories can be more relevant to a particular company and so demand more of its attention.

Economic Trends

Of the seven categories of trends, we are flooded with opinions and doom-and-gloom prognostications about the economy the most. The news media thrive on stories about how stocks are being buffeted by economic forecasts and events such as bank bailouts or even bailouts of countries like Greece. Unless one has a direct financial stake, a lot of such news is just "noise." Economic data look very different and can provide a more solid feel as to how a country's economy is faring and how its currency is faring with respect to the world's major currencies. Economists monitor a number of principal indicators to identify trends:

- "Structural shift" is a term that describes a trend from an industrial economy to a service economy, or from a predominantly manufacturing to a knowledge-based economy.

- Structural variables are factors such as energy costs rising faster than raw material costs, or general or minimum wage rates changing.
- Inflation and unemployment rates have historically tended to have an inverse relationship; as one goes up, the other typically goes down, and vice versa. Both are affected by fiscal policy controlled by the government and monetary policy controlled by the Federal Reserve Board, which also controls interest rates.
- Interest rates are the most watched economic indicator. These reflect the cost of loans, mortgages, and credit, as well as how much savings and certificates of deposit (CDs) can earn.
- The consumer price index (CPI) is a relative indicator of how far and how fast prices have risen compared to a base year.
- Housing starts are a leading indicator of whether the economy might turn down or up.
- Balance of trade is the net difference in value between a country's exports and imports. A positive figure reflects a trade surplus while a negative figure indicates a trade deficit. For decades, the United States has run an annual trade deficit.
- Exchange rates reflect the value of one country's currency against another. A declining value of the U.S. dollar, for example, means that U.S. exports will be more competitive in world markets and imports more expensive, while a rising value of the dollar means that imports will become cheaper and U.S. goods in world markets more expensive.
- Personal disposable income is often associated with income data (demographic) and very useful when combined with demographic data such as geographic data, age, and ethnicity.

Regulatory/Legislative Trends

Regulations differ from laws in that they are made and enforced by city, state, and federal regulatory agencies whereas legislation refers to laws enacted by state assemblies and Congress. For both laws and regulations, indications of impending changes can be discerned by close observation of the political process at the appropriate level of government. Also, rules are made according to well-defined processes that include opportunities for rebuttals by industry or interested parties.

- The volume of regulations enacted each year keeps increasing as reflected in the number of pages in the Federal Register devoted to them.
- It behooves a company to monitor potential changes to regulations governing the industry in which it competes. Some industries, such as railroads and airlines, are so heavily regulated that they are called "regulated industries."
- Many regulations cut across all industries. Examples of these include tax regulations, workplace safety, insider trading, bargaining in good faith in labor negotiations, anticompetitive practices, and price-fixing. All industries encounter some form of regulation, even those not considered "regulated."
- Deregulation of an industry can have an enormous impact. Examples of deregulated industries are telecommunications and electric power. Other industries such as airlines, banking, and transportation have seen a degree of deregulation.

- The merging of industries can have enormous implications for companies in each. An example of this trend has been the convergence of the banking, insurance, and brokerage industries into what is now called financial services.
- The standards set by regulation in an industry may change. In the automobile industry, for example, this can be seen in the standards for crash resistance, fuel economy, and exhaust emissions. Other industries are affected by environmental standards for allowable concentrations of contaminants or impurities in air and water. Labeling requirements on all packaged and processed foods is another such example.
- Trade regulations at the international level may impose tariffs or set quotas to limit imports into a country or make imported goods more costly. Regulations may also prohibit the importation of certain agricultural products or require the quarantining of animals to prevent diseases or invasive species from entering the country.
- All the preceding regulatory trends affecting an industry may occur at both state and federal levels, as well as in many foreign countries.

Political Trends

Politics is not just for politicians. Politics is about power, the powerless, and the actions and activities people take to redress perceived inequities. The "Occupy" movement that spread from Wall St. to Main Street in many cities across the country is a stunning example of this. Such trends could have a significant effect on some companies and their perceived public reputation.

- The relative influence and power of interest groups in every sphere of economic and social activity in the United States is a matter of growing debate. From professional organizations such as the American Medical Association, to industry groups like the National Association of Manufacturers and demographic collectives exemplified by the American Association of Retired Persons (AARP), interest groups are more organized and more influential than ever before. The term *lobbyist* is used in some circles as a pejorative term, giving some indication as to the controversial nature of this trend.
- Fighting against or demanding enforcement of regulations or laws is a trend observed in the nation's courtrooms.
- The United States has always been a highly litigious society and that trend is only increasing.

Demographic Trends

This category is important only to companies that market directly to consumers. Because many companies' products target specific demographic groups, monitoring trends in this category is imperative. Demographic trends are by definition concerned with groups identifiable by specific common characteristics such as age, gender, income, national heritage, and many others.

- A country's population growth (or decline) is a demographic trend with implications for most industries.

- The growth rate of a particular age group such as the 25–39 or over-65 age group gives clues as to whether the population of a country is aging or getting younger, or has a "demographic bulge" moving through it.
- The geographic distribution of population reveals migration patterns affecting local markets.
- Significant trends concerning gender, particularly gender differences, or in conjunction with one or more other demographic characteristics such as age, ethnicity, education, income levels, and others have critical strategic implications in a wide range of industries.
- Changes in ethnic mix reveal the extent to which regions or cities are growing more diverse or becoming dominated by one ethnicity.
- Data on income levels show patterns of wealth distribution and indicate relative purchasing power, especially in combination with geographic data concerning average individual income and household income.
- Literacy rates reflect the extent to which a population has received basic education and can read its own language.

Attitude/Lifestyle Trends

This category of trends also concerns only companies targeting consumers. These shed light on how people live—their patterns of living—making the trends highly interrelated with one another as well as with demographic information. These are also an outward manifestation of people's attitudes and values.

- Household formation includes the family structure one chooses to establish such as married-couple families, one-parent families with either female or male head of household, couples with no children, and gay or lesbian couples. Also of interest is the average number of persons per household.
- Trends in the type of work and who is working are important to consumer-oriented industries. For example, the rise of women in the workforce, especially in professional and technical jobs, and the increase of two-income households have had a tremendous effect on spending patterns and the types of products brought to market. Similarly the tendency of more elderly people delaying retirement and continuing to work is a growing trend.
- Trends in the type and level of education achieved are significant, particularly when the data are combined with ethnicity, race, and sex demographic variables.
- Companies producing for consumers need to be aware of changes in the consumption patterns of goods and services, especially homes, durable goods, furnishings, automobiles, clothes, beverages, and personal services and shifts in patterns within each category.
- Consumer choices with respect to leisure activities are constantly changing. This includes all types of sports and physical-fitness activities, cultural events, movie attendance, travel, and home-centered activities such as watching network and cable television and videos, reading, gardening—anything people choose to do in their free time.

Sociocultural Trends

This category focuses on broader changes in society and the extant culture and becomes important only if societal or cultural changes might affect the business. For example, producing a movie that may not be suitable for young people and therefore is rated NC-17, could in turn translate to lower revenues at the box office.

- Changes in social regulations—such as increases in consumer and environmental protection, changes in Supreme Court rulings, trends of the courts deciding issues that the political process cannot.
- Changing social expectations are constantly in flux. Businesses need to be aware of and prepared to respond to evolving consumer values across a wide range of issues. Examples include changing attitudes toward work, rising consumer demands, greater acceptance of sex and violence in popular culture, a growing emphasis on personal health and physical fitness, and increasing activism among women and minority groups.
- Changes in economic values have recently come to the forefront, most evident in the genesis of the Tea Party and Occupy movements. Many people have expressed increasing concern with how economic benefits are distributed in society and how people are taxed. It can be argued that there is less acceptance of economic growth today as an unqualified benefit to society.
- Changes in political priorities affect entire industries and even regions of the country. For example, choices made between defense versus nondefense appropriations will be of tremendous concern to any business that supplies the military or is located in regions where aerospace contractors or military bases are located.

Technological Trends

This category covers the entire swath of technology, from new energy sources, communication technologies, health care modalities and cures, food, agriculture, product and process innovations, and so on. Clearly, high-tech or technology-based companies must be current on technological developments in their fields and how those advances affect people, businesses, and society. In rapidly changing fields, it is possible to detect early signs of new technologies by going to professional-society meetings and listening to presentations on new processes and techniques, which often precede their introduction by several years.

- The pace of change of basic science or research is manifested in the number and nature of new patents applied for and issued.
- The number and location of new companies formed to exploit new technologies and products based on new technologies are indicators of technology trends.
- Changes in the average percentage of sales spent on research and development (R&D) in a particular high-technology industry and for particular competitors, if publicly held are critical trends for companies to monitor.
- Trends in technology diffusion describe changes in the time required for a new technology to

become accepted in general use.
- Innovation lag indicates the period between when the scientific solution to a technological need is first recognized and the emergence of the first viable product using the solution technology and its successor.

A careful analysis of all relevant environmental trends will provide a company with an indication of strategic opportunities, that is, trends that might have a strong positive impact on the company, and looming threats or trends that might have a strong negative impact on the company. Environmental scanning should not be limited only to the period immediately preceding a strategic-planning session. Ideally, environmental scanning should be an ongoing, year-round activity done by many people throughout the organization. If done year-round, it would be unlikely that the company would be blindsided by any changes in its environment—and it would also be one of the first to notice opportunities as they arise. This last point is worth emphasizing, because the earlier an opportunity is noticed, the more lead time the company would have to exploit it.

Clearly, trends that have an immediate impact within the planning horizon—whether the impact is positive or negative—should receive the greatest attention. Trends that require a longer time to affect the company beyond the planning horizon are correspondingly less important but should nevertheless be monitored. Trends that have no impact on the company should be ignored.

Discussion Questions

1. Which environmental categories most need scanning if your company:
   Produces cell phones?
   Is a mass merchandiser?
   Produces steel tubing?
   Supplies lumber for the construction industry?
   Is a four-year university?
   Publishes books?
   Sells nutritional supplements online?
2. List some sources of information for each category of environmental scanning.
3. We know why environmental scanning is considered part of strategic planning, but why is it part of strategic thinking?
4. Economic and demographic data are often quantitative, which makes it easier to identify trends and their impact on the company. But attitude, lifestyle and sociocultural trends are "soft," subjective, and elusive. How can one understand better what's going on in these areas?
5. Scanning the technological environment is difficult for anyone but scientists or engineers in the field. Realizing what's happening today in this environment is too late, because developing technology takes years. How can one find out now what might be developing several years from now?

6. Assessing threats is a critical part of an external analysis that should precede, or be a part of, the strategic-planning process. But the world is not "convenient" in this respect. Forces that may adversely affect the company are constantly changing. How can a company monitor these so that it is never caught unawares?
7. What happens when threats are underestimated? Whose fault is it? Discuss.

Summary

This chapter explored the importance of and tools to help in analyzing a company's external environment—its industry, competitors, markets, and general environment.

Several useful tools for doing an industry and competitive analysis were presented and discussed, including Porter's five-forces model, industry-attractiveness matrix, strategic-group maps, and critical-success-factor analysis. In addition, identifying the industry's dominant economic characteristics and driving forces add to one's knowledge about the industry and how it might be changing—critical knowledge when deciding what strategy to pursue.

An industry sells its products or services to customers, so a key part of the external analysis is finding out all one can about a company's customers (market). Included in a market analysis is distinguishing between a market, target market, and served market (which could be a niche), determining the size of it and whether it is growing (not to be confused with *industry* growth rate), how far the market is penetrated, what customers' needs are and whether these are changing, the distribution channels used, whether the market is price-sensitive, and any relevant trends, for example, in buying habits.

The chapter then provides a discussion and pointers to scan the general environment for any changes or trends that might favor (opportunities) or adversely affect (threats) the company. The general environment includes seven categories, not all of which are relevant to any one company: economic, regulatory/legislative, political/legal, demographic, attitude/lifestyle, sociocultural, and technological.

Concept Check

Key Terms

bargaining power An ability to dictate the terms—price, delivery, quality, and the like—in a trading negotiation.

concentrated industry One in which a few firms in the industry account for a large portion of total industry sales (opposite of fragmented industry).

critical success factors (CSFs) What a company must do well in order to succeed in the industry; however, they *attach to an industry*, not a company (think of them as constituting "rules of the industry").

distribution channel How a product finally reaches the customer (can include directly via salespeople, wholesalers, distributors, retailers, mail order, and the Internet).

driving forces Trends responsible for how an industry is changing.

entry barriers Factors that could, if sufficiently high (like capital required, distribution channels, brand reputation, technological knowhow, etc.), prevent a company from entering an industry.

fragmented industry One in which no one firm has more than a fraction of a percent in market share (opposite of concentrated industry).

industry attractiveness matrix A weighted technique based on a number of factors to determine how attractive an industry is.

industry attractiveness (I.A.) index The final result achieved from using the industry-attractiveness matrix, usually expressed as a percentage.

market analysis An umbrella term covering the collection and analysis of data and information about a company's customers, which could be companies in another industry or individuals (consumers).

market penetration The proportion of a market that has bought a product/service from the industry (can vary from 0 for a brand new market to 100% and beyond, as when people own more than one car or TV).

Porter's five-forces model An analytical tool developed by and named after Michael E. Porter to assess the five sources of competitive threat extant in an industry and causes of industry profitability.

price sensitivity How sensitive buyers are to variations in price. If a slight drop in price causes customers to buy, they are very price-sensitive; if price goes up a lot and customers still buy, they are not at all price-sensitive.

served market That portion of the target market that is currently served by the company or is the

focus of the company.

strategic-group map A technique to cluster, in a two-dimensional space, strategically similar competitors in industries, especially useful when industries contain disparate competitors.

target market The group of customers targeted by a company (could be companies or consumers, domestic or international).