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UNIT 4 ENVIRONMENTAL ANALYSIS

Objectives

After reading **this** unit, you should be able to understand:

- the importance of **environmental** (external) analysis;
- the **relevant** broad dimensions in a general environment;
- the relationship between the general environment **and** strategy;
- the **PESTEL** framework for analysis **and** the **implications** of its factors;
- **McKinsey's 7S framework** and its role in analysis;
- the structural drivers of change; and
- the differential **impact** of **environmental** influences.

Structure

- 4.1 Introduction
- 4.2 Broad Dimensions of External Environment
- 4.3 PESTEL Framework
- 4.4 McKinsey's 7S Framework
- 4.5 General Environment and Organizations Strategy
- 4.6 Environmental Scanning
- 4.7 Summary
- 4.8 Keywords
- 4.9 Self Assessment Questions
- 4.10 References and Further Readings

4.1 INTRODUCTION

Strategic analysis is basically concerned with the structuring of **the relationship** between a business and its **environment**. The environment in which business operates has a greater influence on **their** successes or failures. **There** is a strong linkage between the changing environment, **the** strategic response of **the** business to such changes and the performance. It is therefore important to understand the forces of external environment the way they influence **this** linkage. The external **environment** which is dynamic **and changing holds both** opportunities and **threats** for the organisations. The organisations while attempting at strategic realignments, try to capture these **opportunities** and avoid the **emerging** threats. At the same **time** the changes, in **the** environment affect the attractiveness or risk levels of various investments of the organizations or the investors.

4.2 BROAD DIMENSIONS OF EXTERNAL ENVIRONMENT

The macroenvironment in which all organizations operate broadly consist of **the economic** environment, **the** political and legal environment, the **socio** cultural aspects and the environment related issues like pollution, **sustainability** etc. The **technological** temper and its progress has been the key driver **behind** the major changes witnessed in the external environment making it increasingly complex.

These factors often overlap and the developments in one area may influence developments in other. For example, the opening up of economy integrated the markets globally and increased the competition between private and public firms. This forced the Indian government to revisit its economic policies. Under its new liberalization policy and economic reforms of 1991, regulations like MRTP, which restricted the size of the business and therefore inhibited their efficiency and competitive levels, were removed with a positive impact on the indigenous industries. However, the delay in addressing to the policies like Indian companies act or Exim policies, organisations both from domestic and abroad still find the Indian business environment not so conducive for business. The current political developments are sure to have more uncertainties in the minds of business people regarding the future policy direction in certain sectors. The social considerations in the context of a developing country like India also plays a critical role in deciding the broad dynamics of the business environment. The clash of ideologies between preserving the Indian ethos and culture and giving a freedom of choice to people often create problems and confusion for business.

4.3 PESTEL FRAMEWORK

Careful analysis of the above factors will help in identifying major trends for different industries. Exhibit-1 shows the PESTEL framework which is most popularly used for such analysis.

The external forces can be classified into six broad categories: Political, Economic, Social, Technological, Environmental and Legal Forces. Changes in these external forces affect the changes in consumer demand for both industrial and consumer products and services. These external forces affect the types of products produced, the nature of positioning them and market segmentation strategies, the types of services offered, and choice of business. Therefore, it becomes important for the organizations to identify and evaluate external opportunities and threats so as to develop a clear mission, designing strategies to achieve long-term objectives and develop policies to achieve short-term goals. Here, we will discuss all the six forces individually and then try to come to the conclusion regarding environmental analysis.

Few indicative points are listed to guide you to find the key forces at work in the general environment. While the framework may be used to understand the most important factors at the present time, it should be primarily used to look into the future impact which may be different from their present or past impact.

Exhibit 1

The PESTEL Framework– Macro-environmental influences. The framework primarily involves the following two areas:

1. The environmental factors affecting the organization;
2. The important factors relevant in the present context and in the years to come.

Political

1. Government stability
2. Political values and beliefs shaping policies
3. Regulations towards trade and global business
4. Taxation policies
5. Priorities in social sector

Economic Factors

1. GNP trends
2. Interest rates/savings rate
3. Money supply
4. Inflation rate
5. Unemployment
6. Disposable income
7. Business cycles
8. Trade deficit/surplus

Socio-cultural Factors

1. Population demographics
 - ethnic composition
 - aging of population
 - regional changes in population growth and decline
2. Social mobility
3. Lifestyle changes
4. Attitudes to work and leisure
5. Education – spread or erosion of educational standards
6. Health and fitness awareness
7. Multiple income families

Technological

1. Biotechnology
2. Process innovation
3. Digital revolution
4. Government spending on research
5. Government and industry focus on technological effort
6. New discoveries/development
7. Speed of technology transfer
8. Rates of obsolescence

Legal

1. Monopolies legislation/Antitrust regulation
2. Employment law
3. Health and safety
4. Product safety

Political: Politics has a serious impact on the economic environment of a country. Political ideology and political stability or instability strongly influence the pace and direction of the economic growth. Also it contributes to the economic environment which is conducive for some businesses to grow or remains indifferent for some businesses and at times is a hurdle. Subsequent to general elections of 2004 in the country, there has been a change in the government at the centre. A new coalition United Progressive Alliance (UPA) led by the Congress party and supported by Left is ruling at the centre and the implications on business can be seen through few of the policy statements announced by the government. Even though the broad policy direction is in line with the policy of an open economy and private sector initiative, the

Common Minimum Programme has identified few priority areas which is going to have an impact different than before. Particularly when there are certain ideologies which view differently the issues like FDI and privatization, the future of different sectors like insurance and banking, aviation and telecommunication have become uncertain.

Looking back into the history due to certain ideological beliefs prevalent in some section of politics, foreign companies like Coca Cola and IBM had to move out of India in the late 70s. Entry barriers, protectionist policies, high tariffs, nationalist pursuits all worked towards a closed economy which continued till the time liberalization policies were introduced in 1991. This situation had a cumulative effect on making the economy weak and the businesses were hardly competitive as compared to the international standards. However in subsequent years, the political consensus developed on issues such as labour reforms, power sector reforms, importance of infrastructure sector is doing a lot good for business. Nevertheless, the deteriorating standards in politics, increasing corruption and the criminal nexus are creating hurdles for business in certain areas.

Activity 1

Identify few key active political forces. Discuss how they are shaping the overall environment in the country.

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Economic: Exhibit 2 gives you a view of broad indicators which give the economic picture of the general environment and these should be carefully looked into while doing the environmental analysis.

Exhibit 2	
Common Economic Indicators	
<p>A. National Income</p> <p>GNP</p> <p>Personal disposable Income</p> <p>Personal consumption</p>	<p>B. Policy Initiatives</p> <p>Monetary policy</p> <p>Fiscal policy</p> <p>Labour and employment policy</p>
<p>C. Savings</p> <p>Personal savings</p> <p>Corporate savings</p> <p>Balance of Payments</p>	<p>D. Foreign Sector</p> <p>Exchange rates</p> <p>Exports/Imports</p>
<p>E. Industry</p> <p>Industry Investment</p> <p>FDI flows</p> <p>Services</p> <p>Infrastructure</p>	<p>F. Sectoral Growth</p> <p>Agriculture</p> <p>Industry</p>
<p>G. Capital Market</p> <p>Equity market</p> <p>Bond market</p>	<p>H. Prices, Wages, Productivity</p> <p>Inflation</p> <p>Labour productivity</p>

Economic factors throw light on the nature and direction of the economy in which a firm operates. The firms must focus on economic trends in segments that affect their industry. For example the present trend of low interest rates on personal savings may compel individuals to move towards equity and bond markets leading to a boom in the capital market activity and the mutual fund industry. Consumption patterns are usually governed by the relative affluence of market segments and firms must understand them through the level of disposable income and the tendency of people to spend. Interest rates, inflation rates, unemployment rates and trends in the gross national product, government policies and sectoral growth rates are other economic influences it must consider.

The services sector's contribution to national income is increasing year after year and the family incomes are rising faster than individual incomes, job opportunities are more diverse and therefore these speak for different types of opportunities and challenges which are emerging before the business. With the opening up of the economy, trends in global market needs a careful look.

The above needs to be analyzed and incorporated in your inferences for the general environment and its other forces and how all these together may influence business.

Activity 2

Suppose the foreign exchange reserves in the country gets depleted by half of the present level because of few developments in the outside world. Discuss the environmental effects it may lead to.

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Social

Demographic Factors: Demographic characteristics such as population, age distribution, literacy levels, inter-state migration, rural-urban mobility, income distribution etc. are the key indicators for understanding the demographic impact on environment. The shifts in age distribution caused by improved birth control methods have created opportunities for youth centric products ranging from clothes to entertainment to media. The growing number of senior citizens and their livelihood needs have been highlighted and the government is being forced to pay more attention in the form of social security benefits etc.

Considering Literacy and the composition of literates in the country creates opportunities for particular type of industries and type of jobs. For example on one hand, the presence of a large number of English speaking engineers encouraged many software giants to set up shops in India and on the other, the availability of cheap labour, India becomes a destination for labour intensive projects. Moreover, large labour mobility across different occupations and regions, in recent times, has cut down wage differentials greatly and this has an impact for business which needs to be understood.

Cultural Factors: Social attitudes, values, customs, beliefs, rituals and practices also influence business practices in a major way. Festivals in India offer great business opportunity for certain industries like clothes and garments, jewellery, gift items, sweetmeats and many others, the list could be endless.

Social values and beliefs are important as they affect our buying behaviour. For example, Mc Donalds does not serve the beef burgers in India because Indians do not

have cow meat since the animal is considered holy and sacred. A related example of Walt Disney also brings out clearly, the impact different cultures may bring to business. Walt Disney which has been so successful in US market could not be so similarly successful in European countries because of the difference in the way in which people entertain themselves there. Walt Disney had to customize its offerings in order to be successful in these markets. The spread of consumerism, the rise of the middle class with high disposable income, the flashy lifestyles of people working in software, telecom, media and multinational companies seem to have changed the socio-cultural scenario and this needs to be understood deeply.

Values in society also determines the work culture, approach towards stakeholders and the various responsibilities the organization thinks of owing to its stockholders and the society.

Activity 3

There has been a thrust on women literacy. Discuss the influences you see in the social environment and their impact on business.

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Technology: Technological factors represent major opportunities and threats which must be taken into account while formulating strategies. Technological breakthroughs can dramatically influence the organisation's products, services markets, suppliers, distributors, competitors, customers, manufacturing processes, marketing practices and competitive position. Technological advancements can open up new markets, change the relative position of all industry and render existing products and services obsolete. Technological changes can reduce or eliminate cost barriers between businesses, create shorter production runs, create shortages in technical skills and result in changing values and expectations of customers and employees.

The impact of information technology (IT) which combines fruits of both telecommunications and computers has been revolutionary in every field. Not only has it opened up new vistas of business but also has changed the way the businesses are done. IT has specifically brought in another dimension 'Speed' which organizations recognize as the additional source of competitive advantage beyond low cost and differentiation. Manufacturers, bankers and retailers have used IT to carry out their traditional tasks at lower costs and deliver higher value added products and services.

Activity 4

Enumerate few of the technological advances in the field of agriculture and discuss its role in tapping better opportunities in the overseas market.

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Environment: Environment conservation and protection is an issue, which has gained prominence because of deteriorating environmental balance which is threatening the sustainability of life and nature. Largely, business is also held responsible for such situations as emissions from industries polluting the air, excessive chemical effluents drained out in water making it poisonous and unfit for use, usage of bio non-degradable resources affecting the bio-chain adversely and exposure of employees to hazardous radiations bring their life in danger. All these have been taken very seriously by different stakeholders in the society including the government and legislations and movements are creating pressure for an environment friendly business. These have far reaching implications for business ranging from the kind of business, the product being manufactured, how it is manufactured and how friendly it is for mankind and nature. Big companies like Coca Cola and Pepsi have also come under the purview of the society regarding the environmental hazards. If the charges on them of using chemicals beyond accepted levels for manufacturing soft drinks are confirmed, they will have a black spot on their names and business. So, it is important for the organisations to take care of the environment as well.

Activity 5

List out five major industries which in your view, pose danger to environmental conditions. Mentioning your reasons suggest how these industries may correct the situation.

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Legal: Licensing policies, quota restrictions, import duties, Forex regulations, restrictions on FDI flows, controls on distribution and pricing of commodities together made business difficult during license permit raj before the liberalization policy of 1991. However, with economic reforms things have changed and legal formalities have eased. Nevertheless with globalization, the rules of competition, trade mark rights and patents, WTO rules and implications, price controls and product quality laws and a number of other legal issues in individual countries have become important and therefore they need to be included while understanding the general environment.

Activity 6

Discuss the legislation on patents in India and comment on its impact on the business.

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4.4 MCKINSEY'S 7S FRAMEWORK

Let us now use blank grid for PESTEL analysis to understand the role of McKinsey's 7S framework.

Exhibit 3

BLANK GRID FOR PESTEL ANALYSIS

	Political	Economic	Social	Environmental	Technological
Local					
National					
Global					

The starting point would be to brainstorm an appropriate PESTEL checklist, using the boxes in Exhibit 3. The PESTEL checklist can be used to analyze which factors in the environment are helpful to the unit, and which may impede progress of the unit in achieving its aims. There is of course a danger, common to all checklists, that once an entry has been made under each of the headings it is deemed complete, regardless of whether or not the list reflects the complexity of the reality. Another common error in the implementation is that 'boxes' are completed without reference to the aims of the organisation. This can lead to considerable expenditure of time and energy for little benefit.

Let us now discuss in brief McKinsey's 7S framework. According to Waterman et al., organizational change is not only a matter of structure, although structure is a significant variable in the management of change. When we talk of an effective organizational change, we can see that it is a complex relationship between strategy, structure, systems, staff, style, shared values, skills and superordinate goals. This relationship is represented in a pictorial manner in Figure 4.1.

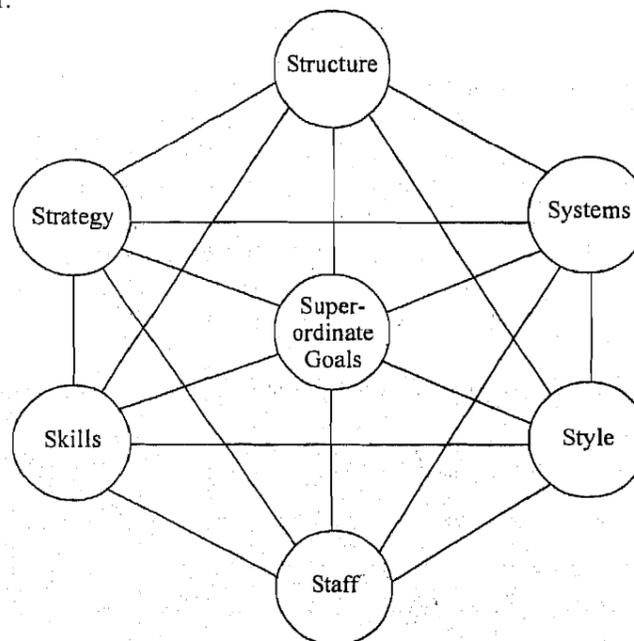


Figure 4.1: The McKinsey 7-S Framework

Source: Thomas J. Peters and Roberts H. Waterman, Jr., *In Search of Excellence: Lessons from America's Best Run Companies* (p.10)

The framework suggests that there is a multiplicity of factors that influence an organisation's ability to change and its proper mode of change. Because of the interconnectedness of the variables, it would be difficult to make significant progress in one area without making progress in the others as well. There is no starting point or implied hierarchy in the shape of the diagram, and it is not obvious which of the seven factors would be the driving force in changing a particular organisation at a certain point in time. The critical variables would be different across organisations and in the same organisation at different points of time.

In this context there may be a role for using 'McKinsey's 7S Framework' helping a unit, structure the analysis. Let us first discuss the concept of McKinsey's 7S framework in brief:

Superordinate Goals: are the fundamental ideas around which a business is built;

Structure: Salient features of the unit's organisational chart (e.g. degree of hierarchy, presence of internal market, extent of centralization/decentralization) and interconnections within the office;

Systems: procedures and routine processes, including how information moves around the unit;

Staff: Personnel categories within the unit and the use to which staff are put, skill base, etc.;

Style: Characterization of how key managers behave in order to achieve the unit's goals;

Shared Values Strategy: The significant meanings or guiding concepts that the unit imbues on its members;

Skills: Distinctive capabilities of key personnel and the unit as a whole.

The 7S model can be used in two ways:

- Considering the links between each of the Ss one can identify strengths and weaknesses of an organization. No S is strength or a weakness in its own right; it is only its degree of support, or otherwise, for the other Ss which is relevant. Any Ss that harmonises with all the other Ss can be thought of as strengths and weaknesses.
- The model highlights how a change made in any one of the Ss will have an impact on all the others. Thus if a planned change is to be effective, then changes in one S must be accompanied by complementary changes in the others.

4.5 GENERAL ENVIRONMENT AND ORGANIZATIONS' STRATEGY

As a next important step the manager needs to analyze the kind of impact the change may bring in their own industry as the impacts are never same for all industries. For example, the emerging younger demographic profile of India will have very different consequences for businesses say in health care or entertainment. While the former will face an adverse effect, the latter will have a positive effect and this needs to be analyzed and integrated into strategic decision making. In response to these assessments of differential impacts, managers will be able to take advantages of the opportunities or guard themselves of the threats. Exhibit 4 shows in how different ways various industries get affected by the different environmental trends.

Responding to these various impacts with new strategic initiatives the managers must take notice of the fact that if the changes are significant, it may have the potential of changing the competitive rules of the game in the industry. For example, in India the

competitive rules of the game for sectors like telecoin, banking and insurance etc, in the post liberalization period changed specially in last two years. With the easing of FDI and participation of major global players, norms have changed drainatically which is reflected in the strategies of most of the firms in the sector. These changes can be seen in the area of technology and pricing, intensity of advertising and promotions, their business alliances and network in the country.

Managers need to be cautious of the fact that there may be developments, which are not so easy to be predicted and therefore need further attention so that they can be incorporated in their strategy. In the global context, the managers must see the kind of impact any single change will have in different markets. It is quite possible that they are very different both in degree and their nature.

Exhibit 4			
Environmental Trends	Potentially positive effects	Probably neutral effects	Probably negative effects
1. Aging population	medical services	minerals	colleges and schools
2. Multiple income families	fast food	machine tools	grocer's supplies
3. Deregulation	shipping		financial sector
4. Increased environmental legislation	waste management	software	leather
5. Growing global	telecommunication small scale/handicrafts	competition	mining

Structural Drivers to Change

The PESTEL analysis gives a number of factors and their likely influences. However it is important to identify the specific factors which may influence an industry and force them towards competitive adjustments. These factors are termed as structural drivers of change which have the likely effect on the structure of an industry or on the competitive environment.

As a first step based on PESTEL analysis, the key driving forces need to be identified and then impact of the combined effect of these forces should also be made. Increasing globalization of the industry and the E enabled era could be such driving forces capable of affecting the structure of an industry or its environment.

4.6 ENVIRONMENTAL SCANNING

The factors or the forces understood under PESTEL framework put together, present a highly complex and uncertain environment which are difficult to predict or foresee. From a long term view of strategy however, reaching somewhat closer to such forces are important in understanding the key factors influencing the success of such strategies.

Environmental scanning is one of the few ways to detect future driving forces early and this involves studying and interpreting the developments of social, political, economic, ecological and technical events that could become driving forces. It attempts to figure out few radical happenings or path breaking developments which may be catching on and see their possible implications 5 to 20 years into the future. The purpose of the environmental scanning is to raise the consciousness of managers about potential developments that could have an impact on industry conditions and bring in new threats or opportunities.

Environmental scanning is normally accomplished by systematically monitoring and studying current events, constructing scenarios and employing the Delphi method (a technique for finding consensus among a group of knowledgeable experts).

Constructing scenarios involves a detailed plausible view of how the business environment of an organization might develop in the future based on the groupings of key environmental influences and drivers of change about which there is high level of uncertainty. For example in industries like energy, transportation, defence equipment etc. there is a need for views of the business environment of more than 10–15 years and factors like raw materials, substitutes, consumption patterns, geo politics etc. would be of crucial importance. Foreseeing precisely for such a longer duration may be very difficult but drawing up possible futures may be possible. It is not unnatural to believe that several scenarios could unfold overtime and these need to be understood.

Scenario Planning technique is briefly discussed in Unit 5 under the competitive environment.

4.7 SUMMARY

Understanding of the general environment in which an organization operates is the foremost pre-requisite towards strategy formulation. The six broad dimensions which the PESTEL framework provides of the environment-political, economic, socio-cultural, technological, environmental and legal are capable of giving a comprehensive overview of how things may be unfolding. The objective of the analysis out of this framework however should not only restrict to the present and past but the real focus should be on projecting the trends into future in order to get the real feel of the environment then. This shall enable the firm to proactively strategize for future considering the general environment, it is going to face and the issues which will be of importance.

4.8 KEY WORDS

PESTEL Framework: This framework categorizes environmental influences into Six main types – political, economic, social, technological, environmental and legal.

Shared Values: The significant meanings or guiding concepts that the unit imbues on its members.

Structural Drivers of Change: factors which have the likely effect on the structure of an industry or on the competitive environment.

Environmental Scanning: One of the few ways to detect future driving forces.

4.9 SELF ASSESSMENT QUESTIONS

- 1) Briefly summarize what you understand by the general environment and its importance for business.
- 2) Explain what is external analysis and how is it connected to strategy formulation?
- 3) Briefly explain the PESTEL framework.
- 4) Discuss the role of McKinsey 7S model in analyzing external environment.
- 5) Identify an industry of your choice and do a PESTEL analysis. Draw up few inference points.

4.10 REFERENCES AND FURTHER READINGS

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UNIT 5 COMPETITIVE FORCES

Objectives

After reading this unit you should be able to understand the:

- competitive environment;
- **competitive** forces of the competitive environment;
- Porter's five forces framework to analyze competitive environment;
- process for analyzing the external environment; and
- concepts of strategic groups and scenario planning.

Structure

- 5.1 Introduction
- 5.2 **Competitive Environment**
- 5.3 Porter's Five Forces Framework
- 5.4 Process for Analyzing External Environment
- 5.5 **Scenario Planning**
- 5.6 Summary
- 5.7 Key Words
- 5.8 Self Assessment Questions
- 5.9 References and **Further Readings**
- Appendix

5.1 INTRODUCTION

In unit 4, we discussed the first level of the external analysis i.e. understanding of the macro environment, which have an influence on the success or failure of an **organisation's** strategies. However, it is the immediate **competitive environment** which also influences an organisation and therefore has to be understood alongside the general environment. The impact of the changes of the macro environment is felt on the organisation and its strategies through their influences on the competitive forces of the competitive environment. **Hence an indepth understanding of the industry's** competitive character is the next important step for an **organization** as part of its external analysis.

5.2 COMPETITIVE ENVIRONMENT

The competitive environment refers to the situation which Organisation's face within its specific area of operation, and this can be understood at an industry level or with respect to smaller groups called Strategic **groups** (Refer appendix). Generally understood, an industry in the economy is recognized as a group of firms producing the same principal product or more broadly the group of firms producing products that are close substitutes for each other and in a given industry different organisations have different intermediate basis of understanding its relative position with respect to other organisations in the industry.