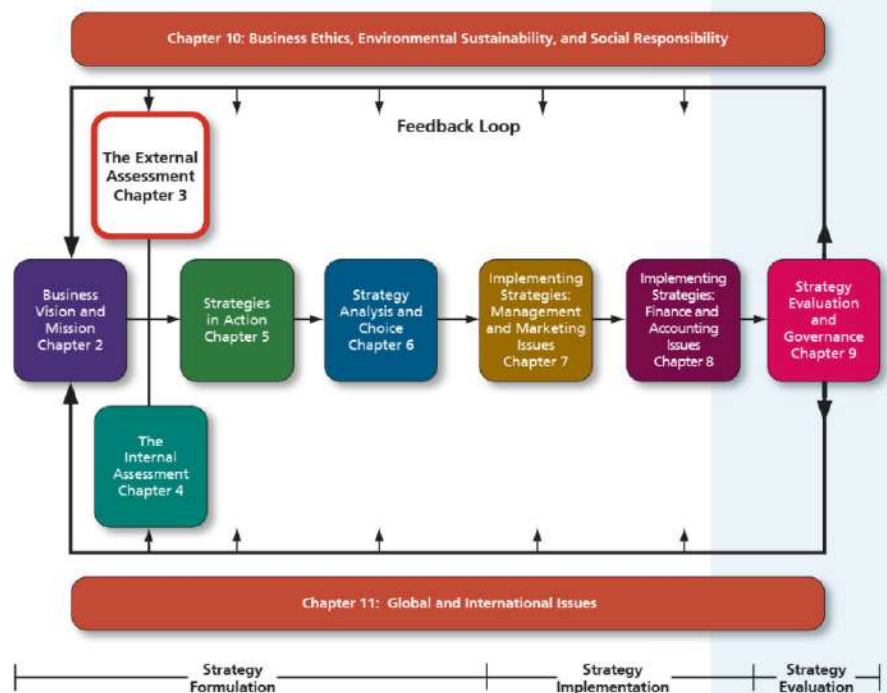


Chapter 3

The External Assessment

The Comprehensive, Integrative Strategic-Management Model



Learning Objectives

- *After studying this chapter, you should be able to do the following:*
 - *Describe the nature and purpose of an external assessment in formulating strategies.*
 - *Identify and discuss 10 external forces that impact organizations.*
 - *Explain Porter's Five-Forces Model and its relevance in formulating strategies.*
 - *Describe key sources of information for identifying opportunities and threats.*
 - *Discuss forecasting tools and techniques.*
 - *Explain how to develop and use an External Factor Evaluation (EFE) Matrix.*
 - *Explain how to develop and use a Competitive Profile Matrix (CPM).*

Preface

- *Companies and organizations continually deal with external uncertainties and must quickly adapt to change to survive.*
- *This chapter focuses on the concepts and tools needed to manage external uncertainties by conducting an **external audit** (sometimes called **industry analysis**).*
- *An external audit reveals key opportunities and threats confronting an organization;*
- *An external audit guides managers in formulating strategies that take advantage of the opportunities and avoid or reduce the impact of threats.*
- *This chapter presents a practical framework for gathering, assimilating, analyzing, and prioritizing external information that provides a foundation for formulating strategies effectively.*

The External Assessment Phase of Strategy Formulation

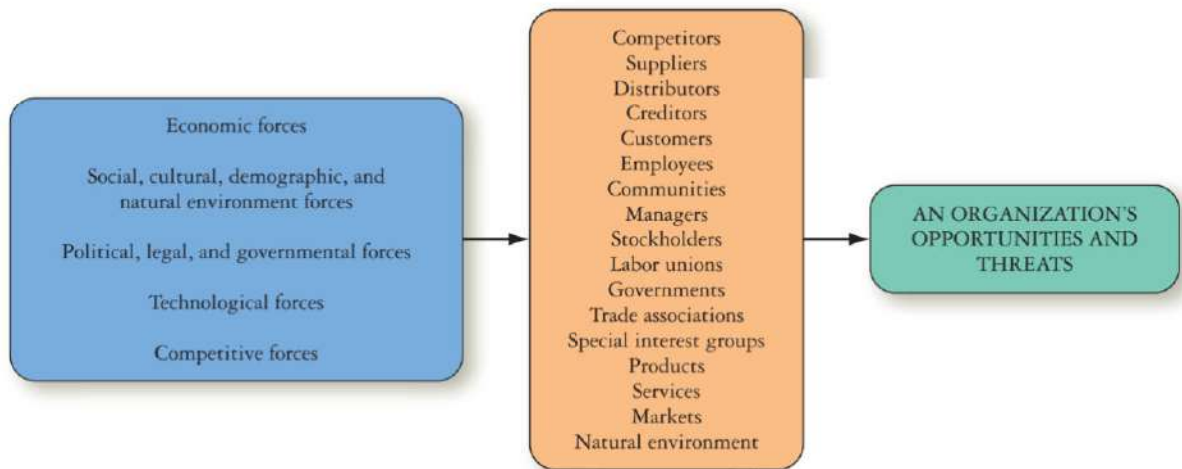
- *The purpose of an external audit is to develop a **finite** list of both opportunities that could benefit a firm and threats that should be avoided or mitigated.*
- *As the term **finite** suggests, the external audit is **not** aimed at developing an exhaustive list of every possible factor that could influence the business; rather, it is aimed at identifying key variables that offer actionable responses.*

Key External Forces

- *There are 10 external forces that can be divided into 5 broad categories:*
 1. *Economic forces;*
 2. *Social, cultural, demographic, and environment (SCDE) forces;*
 3. *Political, governmental, and legal forces;*
 4. *Technological forces;*
 5. *Competitive forces.*

Key External Forces

- Relationships among these forces and an organization are depicted in Figure



AQCD Test

- When identifying and prioritizing key external factors in strategic planning, make sure the factors selected meet the following four criteria to the extent possible:
 - Actionable** (i.e., meaningful and helpful in ultimately deciding what actions or strategies a firm should consider pursuing)
 - Quantitative** (i.e., include percentages, ratios, dollars, and numbers to the extent possible);
 - Comparative** (i.e., reveals changes over time),
 - Divisional** (relates to the firm's products and/or regions (rather than consolidated) so inferences can be drawn regarding what products and regions are doing well or not)
- Factors that meet the four criteria described above pass what can be called the "Actionable-Quantitative-Comparative-Divisional (AQCD) Test," which is a measure of the quality of an external factor

AQCD Test

- *A high quality factor will meet three or four of the AQCD criteria;*
- *A low quality factor will meet two or fewer of the AQCD criteria.*

	ASK YOURSELF IS THE FACTOR			
	Actionable	Quantitative	Comparative	Divisional
A High Quality External Factor				
Online retail grocery shopping grew from 12% to 16% in 2018.	yes	yes	yes	yes
A Low Quality External Factor				
Consumers' average disposable income increased greatly in 2018.	no	no	no	no

AQCD Test

- *Changes in external forces translate into changes in demand for both industrial and consumer goods and services.*
- *External forces affect the types of products developed, the nature of market segmentation and positioning strategies, the range of services offered, and the choice of businesses to acquire or sell.*
- *External forces have a direct impact on both suppliers and distributors.*
- *Identifying and evaluating external opportunities and threats enables organizations to revise their vision and mission if needed, to design strategies to achieve long-term objectives, and to develop policies to achieve annual objectives.*

External Forces Impact

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10 External Forces Impact

- *Economic Forces*
- *Social, Cultural, Demographic, and Environment (SCDE) Forces*
- *Political, Governmental, and Legal Forces*
- *Technological Forces*
- *Competitive Forces*

Economic Forces

- *An example of an economic variable is “value of the dollar,” which can have a significant effect on financial results of companies with global operations.*
 - *Domestic firms with significant overseas sales, such as McDonald’s, are hurt by a strong dollar.*
 - *Domestic firms with significant overseas sales, such as McDonald’s, are hurt by a strong dollar.*
- *A few categories of economic variables that often yield AQCD opportunities and threats for organizations are provided in the following Table ...*

Example of Economic Forces

Shift to a service economy	Demand shifts for different goods and services
Availability of credit	Income differences by region and consumer groups
Level of disposable income	Price fluctuations
Propensity of people to spend	Foreign countries’ economic conditions
Interest rates	Monetary and fiscal policies
Inflation rates	Stock market trends
Gross domestic product (GDP) trends	Tax rate variation by country and state
Consumption patterns	European Economic Community (EEC) policies
Unemployment trends	Organization of Petroleum Exporting Countries
Value of the dollar in world markets	(OPEC) policies
Import/export factors	

SCDE Forces

- *SCDE forces impact strategic decisions on virtually all products, services, markets, and customers.*
- *Small, large, for-profit, and nonprofit organizations in all industries are being staggered and challenged by the opportunities and threats arising from changes in SCDE variables.*
- *These forces are shaping the way people live, work, produce, and consume.*
- *New trends are creating a shift in consumer demands and, consequently, a need for different products, new services, and updated strategies.*

SCDE Forces

- *For example, consumers in the United States now desire automobiles with greater space and utility, in lieu of sedans.*
- *In response to this external trend, Ford Motor recently invested \$7 billion in higher-margin trucks and SUVs and announced plans to reintroduce the Ranger Truck and the Bronco SUV in North America.*



Example of SCDE Forces

Population changes by race, age, and geographic area	Attitudes toward retirement
Regional changes in tastes and preferences	Energy conservation
Number of marriages	Attitudes toward product quality
Number of divorces	Attitudes toward customer service
Number of births	Pollution control
Number of deaths	Attitudes toward foreign peoples
Immigration and emigration rates	Energy conservation
Social Security programs	Social programs
Life expectancy rates	Number of places of worship
Per-capita income	Number of religious members
Social-media pervasiveness	Social responsibility issues

Political, Governmental, and Legal Forces

- *Politics, governments, and legislators can and often do impact strategic decisions.*
- *Federal, state, local, and foreign governments are major regulators, deregulators, subsidizers, employers, and customers of organizations.*
- *Political, governmental, and legal factors, therefore, can represent major opportunities or threats for both small and large organizations.*
- *For industries and firms that depend heavily on government contracts or subsidies, political forecasts can be the most important part of an external audit.*

Political, Governmental, and Legal Forces

- *State and local income taxes and property taxes, for example, impact where companies locate facilities and where people desire to live.*
- *Nine U.S. states, for example, have zero state income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming, New Hampshire, and Tennessee.*

Example of Political, Governmental, and Legal Forces

Natural environmental regulations	United States versus other country relationships
Protectionist actions by countries	Political conditions in countries
Changes in patent laws	Global price of oil changes
Equal employment opportunity laws	Local, state, and federal laws
Level of defense expenditures	Import–export regulations
Unionization trends	Tariffs, particularly on steel and aluminum
Antitrust legislation	Local, state, and national elections

Technological Forces

- *A variety of new technologies such as*
 - *the Internet of Things,*
 - *three-dimensional (3D) printing,*
 - *predictive analytics,*
 - *quantum computing, robotics,*
 - *artificial intelligence*

fueling innovation in many industries and impacting strategic-planning decisions.

Technological Forces

- *Cisco Systems recently entered the data analytics business is that sales of hardware, software, and services connected to the Internet of Things is expected to increase to \$7.1 billion by 2020 from approximately \$2.0 billion in 2015.*
- *Walmart Stores, Inc. in 2018 changed their name to Walmart, Inc.—removing the word stores. In fact, in terms of online selling of groceries, Walmart is the leader in China.*
- *Adidas is shifting to produce footwear in developed countries using fully robotic plants called “speed-factories.” Adidas’s speed- factories are now located across the world, including in Germany, the United States, France, China, and Japan.*
 - ↳ *Adidas’ new strategy aims to eventually surpass its major rival Nike.*

Technological Forces

- *Technological advancements impact firms in countless ways, such as the following:*
 1. *They can dramatically affect organizations' products, services, markets, suppliers, distributors, competitors, customers, manufacturing processes, marketing practices, and competitive position.*
 2. *They can create new markets, result in a proliferation of new and improved products, change the relative competitive cost positions in an industry, and render existing products and services obsolete.*
 3. *They 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 employees, managers, and customers.*
 4. *They can create new competitive advantages that are more powerful than existing advantages.*

Competitive Forces

- *The most important part of an external audit is identifying rival firms and determining their strengths, weaknesses, capabilities, objectives, and strategies.*
- *Competitive intelligence (CI) is a systematic and ethical process for gathering and analyzing information about the competition's activities and general business trends to further a business's own goals.*
- *Various legal and ethical ways to obtain competitive intelligence include the following:*
 - *Reverse-engineer rival firms' products*
 - *Use surveys and interviews of customers, suppliers, and distributors of rival firms*
 - *Conduct fly-over and drive-by visits to rival firm operations*
 - *Search online databases and websites such as www.owler.com*
 - *Monitor relevant trade publications, magazines, and newspapers*
 - *Hire top executives from rival firms*
 - *Purchase social-media data about customers of all firms in the industry*

Key Questions about Competitors

1. What are the strengths and weaknesses of our major competitors?
2. What products and services do we offer that are unique in the industry?
3. What are the objectives and strategies of our major competitors?
4. How will our major competitors most likely respond to current economic, SCDE, political, governmental, legal, technological, and competitive trends affecting our industry?
5. How vulnerable are our major competitors to our new strategies, products, and services?
6. How vulnerable is our firm to successful counterattack by our major competitors?
7. How does our firm compare to rivals in mastering the social-media conversation in this industry?
8. To what extent are new firms entering and old firms leaving this industry?
9. What key factors have resulted in our present competitive position in this industry?
10. How are supplier and distributor relationships changing in this industry?

Porter's Five-Forces Model

- *Harvard Business School Professor, Michael Porter, suggests that firms should:*
 - *strive to compete in attractive industries,*
 - *avoid weak or faltering industries,*
 - *and gain a full understanding of key external factors within that attractive industry.*
- *Given that competitive positioning within an industry is a key determinant of competitive advantage, Porter established the Five-Forces Model*

Porter's Five-Forces Model



Porter's Five-Forces Model

- According to Porter, the nature of competitiveness in a given industry can be viewed as a composite of five forces:
 1. Rivalry among competing firms
 2. Potential entry of new competitors
 3. Potential development of substitute products
 4. Bargaining power of suppliers
 5. Bargaining power of consumers

Rivalry among Competing Firms

- *The most powerful of the five competitive forces and the most traditional factor analyzed by managers.*
- *Intense rivalry among competitors in an industry can decrease overall industry profits.*
- *Offering differentiation helps all firms in the industry by moving away from competing on cost, where unique customers can be better served while maintaining profits for firms.*

Conditions Cause High Rivalry

1. *When the number of competing firms is high*
2. *When competing firms are of similar size*
3. *When competing firms have similar capabilities*
4. *When demand for the industry's products is changing rapidly*
5. *When price cuts are common in the industry*
6. *When consumers can switch brands easily*
7. *When barriers to leaving the market are high*
8. *When barriers to entering the market are low*
9. *When fixed costs are high among competing firms*
10. *When products are perishable or have short product life cycles*

Potential Entry of New Competitors

- *Whenever new firms can easily enter a particular industry, existing firms are likely to face threats of reduced market share.*
- *In such industries, a firm's strategies should deter new firms from entering the market to avoid further saturation of the market.*
- *The automotive oil-change industry, for example, has relatively low barriers to entry; whereas the smartphone industry has much higher barriers to entry.*

Example Barriers to Entry

- *Economies of scale,*
- *Specialized know-how,*
- *Strong brand reputation,*
- *Established customer loyalty,*
- *High capital requirements,*
- *Absolute cost advantages,*
- *Highly efficient supply chains,*
- *Specialized distribution channels,*
- *Access to key raw materials,*
- *Possession of patents.*

Potential Development of Substitute Products

- *In many industries, firms are in close competition with producers of substitute products in other industries.*
- *A high threat of substitutes exists when consumer needs can easily be filled by one or more substitute products outside of the firm's industry.*
- *Examples are public transportation and car, bike, and taxi/Uber; natural gas, electricity, and solar power; glass bottles, paperboard containers, and aluminum cans.*
- *Competitive pressures arising from substitute products increase as the relative price of substitute products decline and as consumers' costs of switching decrease.*

Bargaining Power of Suppliers

- *The bargaining power of suppliers refers to the ability of suppliers to raise the price of any inputs into the industry.*
- *This "force" affects the intensity of competitiveness in an industry, especially*
 - *when there are few substitutes available for the product offered by suppliers,*
 - *when the cost of switching to an alternative product offered by a different supplier is high,*
 - *when the industry is not a key source of the supplier's revenues,*
 - *or when there are few suppliers.*
- *Boeing and Airbus, the two largest jetliner manufacturers, are beginning to make a portion of the parts that go into planes because both firms determined too high of a proportion industry profitability was going to suppliers.*

Bargaining Power of Suppliers

- *Firms should pursue a backward-integration strategy to compete with suppliers.*
- *This strategy is especially effective when suppliers are*
 - *unreliable,*
 - *too costly,*
 - *not capable of meeting a firm's needs on a consistent basis,*
 - *or simply have too much bargaining power and are able to charge absorbent prices.*

Bargaining Power of Consumers

- *Bargaining power of buyers refers to the ability of buyers to drive down prices for products offered by companies in a given industry.*
- *This force is strong*
 - *when firms operate in industries that contain a limited number of buyers or that are made up of buyers that have multiple choices of where to buy from;*
 - *when buyers purchase in volume or have low switching costs;*
 - *when the products being purchased are standard or undifferentiated, enabling consumers to negotiate selling price, warranty coverage, and accessory packages to a greater extent.*

Bargaining Power of Consumers

- *Consumers (buyers) gain bargaining power under the following circumstances:*
 - *If they can inexpensively switch to competing brands or substitutes*
 - *If they are particularly important to the seller*
 - *If sellers are struggling in the face of falling consumer demand*
 - *If they are informed about sellers' products, prices, and costs*
 - *If they have discretion in whether and when they purchase the product*

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Competitiveness Across a Few Industries

Industry	Operating Profit (%)
Banking	30.8
Hotels	18.4
Pharmaceutical	8.7
Oil and Gas Extraction	7.5
Fragrances/Cosmetics	7.1
Telecommunications	6.1
Food Manufacturing	5.4
Machinery/Construction	4.9
Paper Manufacturing	4.9
Bookstores	2.9

Bargaining Power of Consumers

- *Firms use mergers and acquisitions and purchase suppliers or buyers (distributors) all as a means to eliminate rivalry,*
- *Acquiring the competition often is associated with paying a premium and dealing with different organizational cultures; although there may be no competitors currently, new competitors may enter with different products and ultimately better serve many current customers.*
- *Purchasing suppliers or distributors takes a firm away from the business they do best, possibly allowing competitors to better develop and improve their products without being bogged down with supply chain issues they know little about.*

Key Sources of Information for an External Audit

- *Unpublished sources include customer surveys, market research, speeches at professional and shareholders' meetings, television programs, interviews, and conversations with stakeholders.*
- *Published sources of strategic information include periodicals, journals, reports, government documents, abstracts, books, directories, newspapers, and manuals.*
- *<http://finance.yahoo.com>*
- *www.hoovers.com*
- *www.morningstar.com*
- *www.mergentonline.com*
- *<http://globaledge.msu.edu/industries/>*
- *Corporate website of companies*

The External Factor Evaluation (EFE) Matrix

- *An External Factor Evaluation (EFE) Matrix allows strategists to summarize and evaluate economic, social, cultural, demographic, environmental, political, governmental, legal, technological, and competitive information.*
- *The EFE Matrix provides an empirical assessment of how well a firm is handling external factors overall, including the firm's effectiveness at capitalizing on opportunities and minimizing threats.*

Steps to Develop an EFE Matrix

- 1. Develop a List of Key External Factors*
- 2. Assign Weights to Key External Factors*
- 3. Assign Ratings to Key External Factors*
- 4. Obtain Weighted Scores*
- 5. Obtain Total Weighted Score*

1. Develop a List of Key External Factors

- Conduct thorough research to gather 50-100 external opportunities and threats across 10 industry-specific areas, aligning with the company's vision, mission, strategies, and Porter's Five Forces.*
- Narrow these to 10 opportunities and 10 threats, excluding strategies.*
- Systematically rank or rate factors (e.g., 1-10 importance or 1-50 ranking) to objectively identify the top 20 key factors, avoiding superficial choices (e.g., irrelevant threats like hurricanes) and focusing on actionable, data-driven insights.*
- Ensure factors are specific, measurable, and actionable (per AQCD criteria) and framed within a narrow industry scope (e.g., discount airlines vs. all airlines) to enhance clarity for strategic analysis.*

2. Assign Weights to Key External Factors

- *Assign each factor in the EFE Matrix a weight from 0.01 (least critical) to 1.0 (most critical) to reflect its relative importance for industry success.*
- *Weights are based on industry impact, not company-specific factors.*
- *Ensure total weights sum to 1.0, with no forced balance between opportunities and threats.*
- *Prioritize factors most impactful to organizational performance across the industry.*
- *List opportunities and threats separately from highest to lowest weight to clarify their strategic priority within the matrix structure.*

3. Assign Ratings to Key External Factors

- *Assign each key external factor a rating from 1 (poor response) to 4 (superior response) based on how effectively the company's strategies capitalize on opportunities or mitigate threats.*
- *Ratings reflect company-specific performance, not industry standards.*
- *Prioritize opportunities for higher ratings if the firm's strategies position it well, boosting the EFE Matrix's total weighted score.*
- *Threats can still receive low ratings if poorly managed, as they risk significant harm.*
- *Align ratings with the firm's competitive advantages and industry subset (e.g., luxury cars vs. all automobiles), ensuring judgments reflect how strategies exploit opportunities or neutralize threats within its specialized market.*

4. Obtain Weighted Scores

- *Along each row in an EFE Matrix, multiply the factor's weight by its rating to determine a weighted score for each factor.*

5. Obtain Total Weighted Score

- *Total Weighted Score Interpretation: The EFE Matrix score ranges from 1.0 (weak) to 4.0 (strong), with 2.5 as average.*
- *Scores below 2.5 signal ineffective external response, necessitating strategic shifts, while scores above 2.5 reflect strong positioning (e.g., 3.5 = outstanding execution; 1.5 = critical underperformance).*
- *Higher scores indicate strategies effectively leverage opportunities and neutralize threats; lower scores reveal failures to adapt, requiring urgent realignment of vision, mission, or tactics.*

The Competitive Profile Matrix (CPM)

- *The Competitive Profile Matrix (CPM) reveals how a focal firm compares to major competitors across a range of key factors.*
- *This comparative analysis provides important strategic information regarding a firm's competitive advantages or disadvantages in a given industry.*
- *A Competitive Profile Matrix (CPM) uses industry-based weights (summing to 1.0) and company-based ratings (1–4 scale) to compare firms on critical success factors (CSFs), which include competitive advantages and industry-specific drivers. Total weighted scores quantify relative performance against rivals.*

The Competitive Profile Matrix (CPM)

- *Unlike the EFE Matrix (assessing a single firm's external response), the CPM compares multiple firms on CSFs that can include both internal and external factors (e.g., advertising, product quality, global expansion).*
- *Weights reflect industry importance (e.g., 0.20 for “advertising”), while ratings (1 = poor; 4 = superior) gauge firm-specific strategy effectiveness. List CSFs from highest to lowest weight; avoid duplicate ratings for competitors on the same factor.*

The Competitive Profile Matrix (CPM)

Critical Success Factors	Weight	Kroger Company		Walmart Inc.		Amazon.com Inc.	
		Rating	Score	Rating	Score	Rating	Score
Price Competitiveness	0.17	3	0.51	4	0.68	2	0.34
Product Quality	0.13	2	0.26	3	0.39	1	0.13
Multiple Formats	0.10	4	0.40	3	0.30	1	0.10
Market Penetration	0.09	4	0.36	3	0.27	2	0.18
Customer Loyalty	0.08	2	0.16	4	0.32	3	0.24
Name Recognition	0.08	1	0.08	4	0.32	3	0.24
Store Locations	0.07	2	0.14	4	0.28	1	0.07
Customer Service	0.07	2	0.14	3	0.21	4	0.28
Market Share	0.06	2	0.12	4	0.24	1	0.06
Financial Profit	0.05	2	0.10	4	0.20	3	0.15
Distribution System	0.05	2	0.10	3	0.15	4	0.20
Advertising	0.05	1	0.05	4	0.20	2	0.10
Total	1.00		2.42		3.56		2.09

Chapter Summary

- *External audits are critical in turbulent markets to assess economic, social, technological, competitive, and geopolitical factors, ensuring strategies align with actionable, AQCD Test-compliant opportunities/threats (actionable, qualitative, comparative, divisional).*
- *Firms failing to systematically monitor external forces risk strategic obsolescence, missed opportunities, and decline—especially those lagging in e-commerce/social media adoption.*
- *Strategists must build robust external-audit systems, integrating tools like EFE Matrix, CPM, and Porter's Five Forces with intuitive judgment and IT-driven competitive intelligence.*
- *Global firms require tailored audit systems to navigate diverse external landscapes, where regional variations in regulations, culture, and competition demand nuanced analysis.*

Topics for Further Collaboration ...

- *Ben Silbermann, CEO and Co-founder of Pinterest (Page 94 – David Book)*
- *Preserve Alaska Wildlife or Boost Alaska Economy? (Page 98 – David Book)*
- *What Company Is Growing Fastest Globally? (Page 101 – David Book)*