

Overview of External Analysis

Introduction

The primary purpose of this video is to give you a high-level overview of external analysis and help you to, first, understand the purpose of external analysis and the types of insights we hope to gain. Second, gain exposure to a few key tools for external analysis. And third, show you how these key tools work together to help you generate strategic insight.

The external environment

Every company operates in an external environment. You may or may not have any control or influence over that external environment, but in all cases the external environment presents both threats and opportunities for you to consider in your decision-making.

If you were a fish and we wanted to know whether or not you can be the biggest fish in the pond, we might start by examining the pond itself. There may be other fish in the pond, so we want to understand something about the nature of competition between and among fish in the pond. Do they generally cooperate with each other, or do they fight viciously with each other for limited resources? We may want to understand something about the critical supplies. Is there sufficient oxygen in the water? Is there a sufficient food source to sustain growth?

But we also want to understand future trends that might affect the pond. Is there a local climate shift that may change the availability of resources in the pond? Or is there a drought that may eliminate the pond altogether? These all seem like very important questions for our fish to explore but note that none of them are about the fish itself. These are all questions about the external environment of the fish.

Tools for external analysis

The tools of external analysis, likewise, give us insights about the external environment of the company, not the company itself. For all of our external analysis tools, we are examining entities and situations that are outside of the company.

Analyzing the competitive environment

To complete an external analysis for a particular company, we first need to identify and clearly define the competitive environment in which the company competes. If we manufacture automobiles, then we need to identify the competitive environment we want to analyze. Are we analyzing the global auto industry? Or just the US auto industry? Or just the EU auto industry? Are we analyzing the economy car segment or the midsize car segment or the luxury car segment? Or, maybe we're analyzing the competitive environment for luxury cars only in the EU geography? It is important for us to create some conceptual boundaries around our competitive environment so that we can perform a consistent and meaningful external analysis.

Conceptually, we can now draw a circle that represents our competitive environment. Competitor companies, or companies that do what we do and may compete with us for customers, go inside of the circle. These are companies that do the same jobs for customers that we do and that generally do these

jobs in similar ways. Every other company or organization goes outside of the circle. Let's set them aside for now and come back to them later.

We have a few strategy tools to deal with competition within the circle. We can look specifically at competitive dynamics. Do these companies compete aggressively on price for otherwise similar products? Or do they compete through differentiated products? Are these companies cooperating with each other to keep profits high or are they aggressively competing with each other in ways that drive down profits for everyone? Thus, the first analysis we perform leverages our tools of competitive interaction and competitive dynamics within a certain competitive environment.

Now, again, note that we are not analyzing a single company. We're looking at how these various companies inside the circle compete with each other generally.

After we have a solid understanding of the nature of competitive interactions, or they extend rivalry inside the circle, we can bring our attention back to the entities outside of the circle. This is where the tools of Industry Analysis can be particularly useful.

Industry Analysis

Industry analysis requires us to first analyze the nature of competition within the competitive environment and this maps to the tools of competitor interactions I mentioned a moment ago. But the other factors we analyzed in an industry analysis help us to categorize the other entities that are closely related to our circle and evaluate the extent to which they threaten profits within our competitive environment.

Some of these organizations are potential entrants, meaning that they are not currently competing inside of the circle, but they could move into the circle and try to compete directly in the competitive environment. The easier it is for new companies to enter your circle, the more difficult it will be for existing companies to capture profits within the circle.

Some of these organizations or individuals are buyers, meaning that they purchase products and services from the companies within our circle. Buyers want lower prices and better products, so they will try to bargain for both. When buyers have a lot of power, they can shift profits from the companies inside our circle to their own pocketbooks.

Some of these organizations are suppliers, meaning that they provide the products and services to the companies within our circle. Suppliers want higher prices and want to provide low cost products. So, like buyers, they try to shift profits from the companies inside the circle into their own pocketbooks.

Some of these organizations provide substitute products or services, meaning that they satisfy the job's customers are hiring companies in your circle to do but they're doing it in a different way. So, for example, a substitute for purchasing a bottled water is to take a drink from a drinking fountain. The easier it is for your buyers to find appropriate substitutes the harder it will be for existing companies to capture profits within the circle.

Some of these organizations provide complementary products or services, meaning that they provide products or services that when purchased increase demand for the products and services inside your circle. For example, if our circle represents Android smartphones, then Android apps are complements. The more attractive and useful the available android apps, the more attractive android phones will be

for consumers. The more there are attractive complements, the easier it will be for the companies in your circle to capture profits.

Thus, asking careful questions about these various entities helps us understand the extent to which other organizations immediately outside of our competitive environment may affect the overall profitability and the nature of competitive interactions inside of our circle.

Consider for example how an increase in attractive substitutes might affect the nature of competition within our competitive environment. If customers all of a sudden have more attractive substitutes, then our buyers may be less interested in the products and services within our circle overall. Thus, our entire pool of customers shrinks and the companies within our circles start fighting more aggressively for their share of a shrinking marketplace. Typically, this leads to price wars and lower overall profits for the companies inside the circle.

We can do similar analyses for how changes in the other forces will affect the nature of competition within our circle. Now, before we move on, it is important to point out that the tools we've described so far are really best used to take snapshots of your external environment. When we engage these analyses, we are essentially asking how easy or hard is it for competitors inside the circle to capture profits in today's external environment? This is important because, of course, external environments change and this snapshot might look very different in a year, or in five years. Thus, we need some additional tools to help us think about how these snapshots may shift and change.

PEST analysis

The PEST analysis gives us tools to do exactly this. PEST stands for political, economic, social, and technological factors. Let's draw another larger circle that contains all the organizations in our external environment. This circle is what we capture inside the lens of a traditional industry analysis but political, economic, social, and our technical trends may change what our snapshot looks like over time.

From a political perspective, imagine what would happen if a regulation change made it illegal for some of the companies in our competitive environment to sell products or services. All of a sudden, the other companies inside the circle would have a much better chance of being profitable because rivalry would decrease rapidly.

From an economic perspective, imagine what would happen if an economic crash made it so that a large percentage of the buyers could no longer afford to buy these products and services. The companies would have to fight aggressively for fewer buyers and would likely sacrifice profits. The remaining buyers likely have much more power to bargain for better prices and/or better products.

From a social perspective, imagine what would happen if societal preferences shifted such that most consumers felt that the companies in our competitive environment were doing something morally inappropriate, such as negatively impacting the natural environment. As social preferences shift, our pool of potential customers likely shrinks given these social preferences. Again, this likely leads to higher rivalry and higher buyer power for the remaining customers.

From a technological perspective, imagine what would happen if a new technology made substitute products more attractive. Again, the new snapshot would look far less appealing.

Of course, not all trends are concerning. As society has shifted towards a stronger preference for green energy, numerous competitive environments that focus on renewable energy have increased. Wind energy capacity, for example, more than tripled in the eight years from 2008 to 2016. Social shifts towards green energy led to improved performance opportunities for companies in the wind energy competitive environment. Thus, the key value of the PEST model in our external analysis is to help us think through the various political, economic, social, and technological trends, and try to map them carefully to our industry analysis.

How will these trends change the nature of competition and the ease of capturing profits for the companies within our competitive environment? At this point, we have a reasonably complete picture of our external environment and, again, we've analyzed the environment and not the company.

Conclusion

These tools don't really allow us to say anything about the company itself, just the environment in which it is embedded. But, if we do this analysis well, then we know everything we need to know about our external environment today, and we know how our external environment is likely to change in the near future, given the PEST trends. We can then couple our external analysis with an internal analysis to generate a powerful set of strategic insights.

In other words, now that we know something about the pond, we can start to ask questions about the fish.