The External Environment

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Just like the steel and auto industries during earlier decades, the music industry is under siege. In recent years, the technological, economic, legal, and competitive forces have conspired to alter a decades-old business model. The traditional music recording and production companies in the $40 billion music industry are being forced to evolve from selling products to simply providing a service.

Music CDs each cost about $.50 to make, but retail for $15.00 or more. The $15.00 retail price covers the cost of production, marketing, distribution, royalties to the artists, and percentages for the record companies and the retailers. In a major settlement with record companies, the Federal Trade Commission recently concluded that consumers may have overpaid more than $450 million for CDs in the past three years. The agreement requires that record companies change their pricing policies.

The more significant threat to the traditional business model is technological change. The Internet has spawned a series of start-up companies that allow swapping and downloading of music files. Several companies, with Napster being the most famous, capitalized on the ease of transferring MP3 music files. The approach used by these companies is to simply act as a switchboard for matching up customers with their music interests, which allows users to copy music from other users free of charge.

As expected, Napster’s activities have been challenged in court as a violation of copyright laws. A San Francisco federal judge ordered Napster to cease its music transfer operations. Napster has argued that it never takes possession of files or stores them on its server—it just moves the files from one customer to the other. Although the legality of the issue is still being assessed, the implications for the record companies are clear. Why should a record company produce millions of CDs then ship them via distributors all over the world? Why should retailers maintain an inventory of CDs when it is so easy to create a CD on the spot? What is to prevent a well-known music group with a young, Internet-savvy fan base—say, the Backstreet Boys—from just recording their own music then putting it out via their group’s own Web site, circumventing record companies altogether and collecting all of the profits directly?

The implications are profound. In the future, record companies may just control access to copyrighted music rather than participate in production and distribution. According to one industry consultant, “The music business will become about growing the size of the crowd. It becomes more like radio or television.” Payment to artists may be based on a royalty per download. Traditional retailers may be largely cut out of the loop—and, once established, artists may choose to access their market directly. As noted by Time magazine writer, Karl Taro Greenfeld, “Ultimately, it will be technology and economics, not lawyers and mega bands, that will call the tune in the music business. Already, record companies like Sony, Warner, Universal, EMI, and BMG are making plans to sell digital files of music, either as albums or tracks.”
This chapter is about the influence of the external environment on organizations. Although an organization cannot have much direct influence on its broad environment (i.e., society, the economy, technology, global politics), it can buffer itself from threats and take advantage of opportunities. On the other hand, the external stakeholders that compose an organization’s task environment (i.e., customers, suppliers, competitors) are subject to substantial firm influence. As described in the previous example, the fundamental technological trends and the resulting economic trends, both of which are part of the broad environment, are largely beyond the influence of any one firm. The competitive implications—such as the threat of substitute business models like the Napster model, and the relationships with artists, distributors, and retailers—can be influenced by organizations within the music industry. Whether they treat these fundamental changes as threats or opportunities may determine their survival. We will now discuss the broad environment, followed by the task environment.

THE BROAD ENVIRONMENT

Forces in the broad environment can have a tremendous impact on a firm and its task environment; however, individual firms typically have only a marginal ability to influence these forces. In rare cases, individual firms can influence trends in the broad environment, as when innovations at Intel influence technological trends in the microprocessor, microcomputer, and software industries. In general, however, it is virtually impossible for one independent firm to dramatically influence societal views on abortion, policies on free trade with China, migration to the Sun Belt, the number of school-age children, or even the desirability of particular clothing styles. Consequently, although firms may be able to influence the broad environment to some degree, the emphasis in this book generally will be on analyzing and responding to this segment of the environment. The most important elements in the broad environment, as it relates to a business organization and its task environment, are global socio-cultural, economic, technological, and political/legal forces.

Socio-cultural Forces

A few of the major socio-cultural issues currently facing the United States are shown in Exhibit 2.1. Analysis of societal trends is important from at least four perspectives. First, because most of the other stakeholder groups are also members of society, some of their values and beliefs are derived from broader societal influences, which can create opportunities and threats for organizations. For example, societal interest in health and fitness has led to business opportunities in the home fitness and nutritional supplements industries, whereas concerns about smoking have set the stage for a regulatory and legal backlash against the tobacco companies.

Second, firms may reduce the risk of gaining a bad “ethical” reputation by anticipating and adjusting for socio-cultural trends. In the late 1990s, Bill Gates, the founder of Microsoft, was facing rising societal concern about the extraordinary profits generated by Microsoft and by his “unimpressive philanthropic record.” In 1999, he donated $3.35 billion to the William Gates Foundation, which provides grants for health and human services organizations, the Gates Learning
Exhibit 2.1 Major Social Issues in the United States

Role of government in health care and child care
Declining quality of education
Legality of abortion
Influence of World Wide Web
Importance and role of the military
Levels of foreign investment/ownership in the United States
Social costs of restructuring, especially layoffs
Pollution and disposal of toxic and nontoxic wastes
General increase in environmental awareness
Drug addiction
Continued migration toward the Sun Belt states
Graying of America
AIDS and other health problems
Major global issues
Immigration restrictions

Foundation, which gives software, computers, and services to libraries in low-income areas. Some observers speculated that he was giving the money to garner sympathy as he was entering his antitrust investigation. In another example, the Denny’s restaurant chain was known for many years as one of America’s most racist companies. However, Ron Petty, Denny’s CEO, introduced initiatives that turned the company into a model of multicultural sensitivity. In 2000, after two years in the top 10, Denny’s was number one on the list of Fortune’s best companies for minorities.

Third, correct assessment of socio-cultural trends can help businesses avoid restrictive legislation. Industries and organizations that police themselves are less likely to be the target of legislative activity. In 2000, Microsoft was judged to be a monopoly and ordered to break into two separate businesses. Although the judgment is under appeal at the time of this writing, the decision raises the question—could Microsoft have done something to avoid the investigation in the first place? Could they have anticipated and avoided the wrath of competitors and the attention of regulators? In another example of societal concerns about business practices, the United States Sentencing Guidelines (USSG), compulsory guidelines courts must use to determine fines and penalties when corporate illegalities are proven, were a direct response to public outcry over negligence on the part of businesses in preventing white-collar crime.

The fourth reason why analysis of socio-cultural values is important is that demographic and economic changes in society can create opportunities for and threats to the revenue growth and profit prospects of an organization. For example, many baby boomer couples had babies later in life than their counterparts in past generations, causing a demographic trend toward older couples with children. In the 1990s, the higher levels of income of these more established “30- and 40-something” parents led to the development of higher quality baby accessories, clothing, and supplies, as well as new business opportunities in child care and
specialized education. Seemingly unrelated industries, such as the motion picture and television industries, took advantage of these trends by producing many movies and television shows that centered on families and children. In the next several years, more of these aging baby boomers, who were born between 1945 and 1965, will be entering their wealthy empty-nest years and retiring. Their numbers and their wealth will continue to stimulate growth in recreational and leisure industries, and in luxury products and services. Furthermore, the baby-boomers’ children have purchasing power greater than previous generations of children, stimulating demand for music, entertainment, and fashion. They are also entering colleges at a record pace—straining resources on college campuses. Demographic changes such as these can help direct organizational planning and are often at the core of any forecast of industry demand.

Not only must an organization assess the potential effects of socio-cultural forces on its business, it must manage its relationship and reputation with society at large. The media acts as a watchdog for society. It is a commanding force in managing the attitudes of the general public toward organizations. Executives have nightmares about their organizations being the subjects of the next 60 Minutes program or some other news show. On the other hand, a well-managed media can have a significant positive impact on a firm’s image.

**Global Economic Forces**

Economic forces can have a profound influence on organizational behavior and performance. Economic growth, interest rates, the availability of credit, inflation rates, foreign exchange rates, and foreign trade balances are among the most critical economic factors. Economic growth can also have a large impact on consumer demand for products and services. Consequently, organizations should consider forecasts of economic growth in determining when to make critical resource allocation decisions such as plant expansions. Inflation and the availability of credit, among other factors, influence interest rates that organizations have to pay. High interest payments can constrain the strategic flexibility of firms by making new ventures and capacity expansions prohibitively expensive. Low interest rates, such as those experienced in the U.S. in the late 1990s, coupled with fears that the Federal Reserve would raise rates, have led to volatile reactions in the stock market.

Foreign exchange rates are another major source of uncertainty. For global organizations, profit earned in a foreign country may turn into a loss due to unfavorable exchange rates. Finally, foreign trade balances are highly relevant to both domestic and global organizations because they are an indication of the nature of trade legislation that might be expected in the future. For example, the United States has a large trade surplus with the European Union (EU). As a result, American manufacturers who export to the EU are concerned about new protectionist legislation, such as high tariffs, that may be enacted to reduce the trade imbalance.7

The socio-cultural forces discussed in the last section often interact with the economic forces. In the United States, birthrates (a socio-cultural force) are low and, because of improved health care and lifestyles (another socio-cultural force), more people are living longer. This demographic shift toward an older population is influencing the economic forces in society. For example, the older
population means that demand for premium services are high but, simultane-
ously, there are shortages of young workers to fill the entry-level jobs, which
may drive up wage rates and lead to inflation. So, for example, a service firm
tracking these trends may project that its demand will go up as it sells its services
to the older customers, but its wage rates will go up as well, leading to lower unit
profitability.

To assess the effect of the interdependent socio-cultural and economic forces,
organizations often model their business environments using different scenarios.
The scenarios are composed of optimistic, pessimistic, and most likely assump-
tions and interpretations of various economic and socio-cultural trend data col-
lected for the process. Continuing with the previous example, the service firm
may develop demand and wage rate scenarios as a way of considering several
different possible future business environments. These scenarios can be updated
as information becomes firmer, and they may be used for evaluating different
courses of action, such as capacity expansions or investments in labor-saving
technologies.

This brief discussion of economic forces indicates the importance of monitor-
ing and forecasting events in the global economy. We now turn our attention to
the role that technological forces play in the strategic management of organiza-
tions.

Global Technological Forces

Technological change creates new products, services, and, in some cases, entire
new industries. It also can change the way society behaves and what society ex-
pects. The Internet, hand-held computers, direct satellite systems, and cellular
telephones are technological innovations that have experienced extraordinary
growth in recent years, leaving formerly well-established industries stunned, cre-
ating whole new industries, and influencing the way many people approach
work and leisure. Computers and telecommunications technologies, for example,
have played an essential role in creating the increasingly global marketplace.

Technology refers to human knowledge about products and services and the
way they are made and delivered. Technologies typically evolve through a series
of steps, and each step has its own set of implications for managers. When a new
idea or technology is proven to work in the laboratory, it is called an invention.
New inventions are made every day—corporate research laboratories, universi-
ties, and individuals invent new products, new processes, and new technologies
all of the time. Only a handful of those inventions, however, are ever developed
past the laboratory stage. When an invention can be replicated reliably on a
meaningful scale, it is referred to as an innovation. Most technological innova-
tions take the form of new products or processes, such as fax machines, air bags,
and cellular phones. A basic innovation, such as the microprocessor, light bulb,
fiber optics, or mapping of the human genome, impacts much more than one
product category or one industry.

To avoid being blindsided by a new technology, organizations should moni-
tor technological developments in industries other than their own and conduct
brainstorming sessions about the possible consequences for their own products
and markets. For example, drawing from the example at the beginning of the
chapter, record companies might have considered the effect of digital sound
transmissions via the Internet on their traditional business model before being caught off guard by new start-ups like Napster.

To help identify trends and anticipate their timing, organizations may participate in several kinds of technological forecasting efforts. In general, organizations may monitor trends by studying research journals, government reports, and patent filings. Another more formal method of technological forecasting is to solicit the opinion of experts outside of the organization. These experts may be interviewed directly or contacted as part of a formal survey, such as a Delphi study. A third method is to develop scenarios of alternative technological futures, which capture different rates of innovation and different emerging technologies. Scenarios allow an organization to conduct what-if analyses and to develop alternative plans for responding to new innovations.

In addition to forecasting, some organizations establish strategic alliances with universities or research companies to engage in joint research projects, which allows the companies to keep abreast of new trends. For example, most of the established pharmaceutical firms have partnered with small, innovative biotechnology research firms in order to capture the next generation of biotech-driven product and process technologies. Other organizations simply donate funds to universities for research in exchange for information about findings. The Partnership Data Net, a Washington-based information center on partnerships, lists about 3,000 partnerships between schools and businesses. Akzo NV, the Dutch chemical giant with more than 11,000 employees at 161 locations in North America alone, created a massive partnership with 12 U.S. colleges that has paid healthy dividends in terms of new products.

With a well-thought-out plan for monitoring technological trends, an organization can better prepare itself to receive early warnings about trends that will create opportunities and threats. Now we will turn our attention to the global political and legal forces in the broad environment of organizations.

**Global Political/Legal Forces**

Political forces, both at home and abroad, are significant determinants of organizational success. The stakes are often high. Concerns about monopoly business practices have garnered more attention from regulators in recent years. As previously discussed, Microsoft was the subject of a monopoly practices investigation and was determined by the courts to be a monopoly. Final actions are pending. Similarly, a proposed merger between WorldCom and Sprint, the telecommunications giants, came under intense scrutiny from antitrust officials. Government officials wanted Sprint to divest its $50 billion long distance services business as a condition for approval. Instead, the deal fell through.

Governments provide and enforce the rules by which organizations operate. Even in the United States, which is considered a “free” market economy, no organization is allowed the privilege of total autonomy from government regulations. Governments can encourage new business formation through tax incentives and subsidies; they can restructure organizations, as in the cases of the AT&T breakup and the planned Microsoft breakup; and they can totally close organizations that do not comply with laws, ordinances, or regulations. Furthermore, alliances among governments provide an additional level of complexity for organizations with significant foreign operations. Nonprofit organiza-
tions are as subject to government intervention and regulation as for-profit organizations.

Although all organizations face some form of regulation, the trend is toward deregulation and privatization of industries worldwide. In Portugal, for example, the previously regulated, government-owned banking industry has moved toward privatization. In Eastern Europe, many industries are struggling to survive and prosper in an emerging free market economy. In the United States, the last 20 years has brought the deregulation of airline, banking, long distance telephone communication, and trucking industries. The once highly regulated utility industry is undergoing partial deregulation, which is opening up new opportunities but creating competitive threats as well. Regulation protected these industries from competition, but required set prices and strict operating procedures. With deregulation, existing industry competitors face turbulence and unpredictability. However, deregulation also provides opportunities for new firms to enter the market.

The amount of time and effort organizations should devote to learning about regulations, complying with them, and fostering good relationships with regulatory agencies and their representatives depends, in part, on the industry. Some laws and regulations pertain to only one industry, such as nuclear energy, whereas others, such as Food and Drug Administration (FDA) and Environmental Protection Agency (EPA) regulations, apply different regulations to different industries. Some regulations cut across industry boundaries and apply to all organizations, such as those promulgated by the Occupational Safety and Health Administration (OSHA). In some industries, such as pharmaceuticals and military and defense contracting, organizations employ entire departments of analysts that are dedicated to studying regulations and ensuring compliance.

In summary, social forces, the global economy, technology, and the global political/legal forces make up the broad environment, the context in which the firm and its task environment exist. The next section will discuss the task environment.

**THE TASK ENVIRONMENT**

The task environment consists of stakeholders with whom organizations interact on a fairly regular basis. These stakeholders include domestic and international customers, suppliers, competitors, government agencies and administrators, local communities, activist groups, unions, and financial intermediaries. Michael Porter, an economist at Harvard University, assimilated years of economic research into a simple model that helps determine the influence of the first three of these stakeholders—suppliers, customers, and competitors—on competition in an industry. His model will be presented in the next section.11

**Competitive Forces**

Michael Porter integrated the theory of industrial organization economics into a “user friendly” model of the forces that drive industry competition. **Industries** are often difficult to define, but in general they refer to a group of organizations that compete directly with each other to win orders or sales in the marketplace. Porter’s model includes suppliers, customers, and industry competitors.
Competitors are further divided into three types: existing competitors, potential competitors, and indirect competitors. The influence of potential competitors on industry competition is determined by the strength of entry barriers, in other words, the forces that discourage new firms from entering the industry. Indirect competitors sell products that can be substituted for products sold by existing competitors, such as contact lenses and corrective surgery as substitutes for glasses. According to Porter, the five forces largely determine the type and level of competition in an industry and, ultimately, the industry’s profit potential. These forces are illustrated in Exhibit 2.2.

An entire industry (as opposed to a single organization) is placed in the center of the model. One of the most common errors made by new students of strategic management is placing an organization in the middle of the model instead of an industry group. When this happens, substitutes are treated as competing products, which is inconsistent with Porter’s ideas concerning the power of substitutes in influencing competition in an industry. Next we will discuss the factors that determine the strength of each of these five forces.
Customers. Although all customers are important, some are more important than others. For instance, when retail giant Home Depot announced that it would no longer buy carpet from Shaw Industries (because Shaw, a carpet manufacturer, was moving into retail), Shaw’s stock dropped by 11 percent in one day. According to Porter, customers tend to exhibit a powerful force on competition in an industry if the following conditions exist:

1. There are a small number of customers. In this case, losing one customer makes a big difference.
2. The customers make high-volume purchases.
3. The purchases customers make from the industry are large relative to the amount expended for items from other industries. Here customers will expend considerable effort to shop for the best price.
4. The products customers are buying are undifferentiated (also known as standard or generic). This means that customers are not concerned about which company they buy from.
5. The customers earn low profits. Customers who earn low profits are under constant pressure to keep the costs of their purchases down.
6. The customers can easily get accurate information on the selling industry’s costs and demand. This gives them a real edge during negotiations.
7. The customers can easily integrate backward and become their own suppliers. Both Sears and General Motors have been known to buy supplier companies when they are unhappy with pricing.
8. Customers can easily switch from one seller to another.

In combination, these forces determine the bargaining power of customers, that is, the degree to which customers exercise active influence over pricing and the direction of product development efforts. The large discount retailers such as Wal-Mart, Kmart, and Target are powerful because of high-volume purchases and the ease with which they switch from one manufacturer to another for many products.

Suppliers. Suppliers to industries provide equipment, supplies, component parts, and raw materials. The labor and capital markets from which firms draw their employees and investment funds are also a source of supply. Powerful suppliers can raise their prices and therefore reduce profitability levels in the buying industry. They can also exert influence and increase uncertainty for the buying industry by threatening to raise prices, reducing the quality of goods or services provided, or not delivering supplies when needed. In general, supplier power is greater under the following circumstances:

1. Only a few suppliers are available.
2. Few substitutes exist for the product or service that is supplied. (These first two conditions limit the ability of the buying industry to use alternative supply sources as a bargaining tool.)
3. Suppliers are not dependent on the buying industry for a large percentage of their total sales. This means that the loss of one sale is not very important.
4. Suppliers know that the buying industry must have the product or service that suppliers provide to manufacture their own products.
5. Suppliers have differentiated their products, which means that the buying industry is willing to pay more for certain brands.
6. Suppliers make it costly to switch suppliers. IBM built its mainframe business by making IBM mainframes incompatible with other brands, thus preventing buyers from switching.
7. Suppliers can easily integrate forward and thus compete directly with their former buyers.

These forces combine to determine the strength of suppliers and the degree to which they can exert influence over the profits earned by firms in the industry. The notebook computer industry, for instance, is one that is particularly susceptible to the power of suppliers. Most of the industry competitors purchase microprocessors, batteries, operating system software, and flat-panel displays from suppliers. Consequently, the manufacturing costs, performance characteristics, and innovativeness of the notebook computer are largely in the hands of suppliers.

**Existing Competitors.** In most industries, competitive moves by one firm affect other firms in the industry, which may incite retaliation or countermoves. Competitors jockey with each other for market share and for the favorable comments of investment analysts. In many industries, every new product introduction, marketing promotion, and capacity expansion has implications for the revenues, costs, and profits of other competitors. Overall profitability is most susceptible to negative pressures from competitive rivalry in industries characterized by the following:

1. Slow industry growth, which means that competitors must steal market share if they intend to grow.
2. High fixed costs, which mean that firms are under pressure to increase sales to cover their costs and earn profits.
3. Lack of product differentiation, which puts a lot of pressure on prices and often leads to price-cutting strategies.
4. A large numbers of competitors, which means that the total market must be divided in more ways.
5. High exit barriers, which means that firms may lose all or most of their investments in the industry when they withdraw from it. Therefore, they are more likely to remain in the industry even if profits are low.

In many industries, competition is so intense that profitability is suppressed to almost nothing, as has been the case at various times in the airline, small computer, and fast food industries.

**Potential Competitors/Entry Barriers.** Several forces determine the ease with which new competitors can enter an industry and, therefore, how many new entrants can be expected. New entrants increase competition in an industry, which may drive down prices and profits. They may add capacity, introduce new products or processes, and bring a fresh perspective and new ideas—all of which can drive down prices, increase costs, or both. Forces that keep new entrants out, providing a level of protection for existing competitors, are called entry barriers.

Examples of entry barriers that are found in many industries include the following:
1. Economies of scale, which occur when it is more efficient to produce a product in a larger facility at higher volume.
2. Large capital requirements, also known as start-up costs, can prevent a small competitor from entering an industry.
3. High levels of product differentiation, which means that some firms enjoy a loyal customer base, making it harder for a new firm to draw away customers.
4. High switching costs, which apply not only to suppliers, can also serve as an entry barrier protecting established firms in an industry.
5. Limited access to distribution channels, which may prevent new companies from getting their products to market.
6. Government policies and regulations that limit entry into an industry, effectively preventing new competition.
7. Existing firm possession of resources that are difficult to duplicate in the short term, such as patents, favorable locations, proprietary product technology, government subsidies, or access to scarce raw materials.
8. A past history of aggressive retaliation by industry competitors toward new entrants.

Taken together, these forces can result in high, medium, or low barriers. In industries with high entry barriers, few new firms enter the industry, which reduces the competitive intensity and stabilizes profits for industry incumbents. When entry barriers are low, new firms can freely enter the industry, which increases rivalry and depletes profits. Examples of industries that are traditionally associated with high barriers to entry are aircraft manufacturing (due to technology, capital costs, and reputation) and automobiles manufacturing (due to capital costs, distribution, and brand names). Medium-high barriers are associated with industries such as household appliances, cosmetics, and books. Low entry barriers are found in industries such as apparel manufacturing and most forms of retailing. One of the most powerful effects of the Internet has been the ability to circumvent traditional barriers to entry. For many Americans, Amazon.com is as synonymous with book retailing as Barnes and Noble. Amazon, however, never had to face the extraordinary expense of leasing or buying land, building large bookstores in premium retail locations, stocking and maintaining inventories in remote locations, and hiring and training a workforce experienced in the nuances of book retailing. They circumvented those barriers to entry by going straight to consumers with an exclusive Internet strategy.

**Indirect Competitors/Substitutes.** If organizations provide goods or services that readily substitute for the goods and services provided by an industry, those organizations become indirect competitors. For example, aspirin, ibuprofen, and acetaminophen are all substitute pain relievers. In the service sector, credit unions are substitutes for banks and bus travel is a substitute for airline travel. Close substitutes can place a ceiling on the price that an industry can be charged for a good or service. For example, if the price of naproxen (e.g., Aleve) pain reliever/fever reducer becomes too high, many consumers who typically prefer it may switch to aspirin, acetaminophen (e.g., Tylenol), or ibuprofen (e.g., Advil).

Although Porter does not explicitly address other factors in his original model, other stakeholder groups exist that can influence an industry’s profitability. Special interest groups and government agencies, for example, take actions...
that cause organizations to invest money, which can influence cost structures and profits. For example, improvements in automotive fuel efficiency and safety are largely the result of pressures from consumer groups and regulators.

An analysis of the five forces is useful from several perspectives. First, by understanding how the five forces influence competition and profitability in an industry, a firm can better understand how to position itself relative to these forces, determine any sources of competitive advantage now and in the future, and estimate the profits that it can expect. Firm managers may also decide to alter the influence of the five forces by actions such as erecting higher entry barriers through large-scale economies or greater product differentiation, or by creating switching costs to encourage customer loyalty. Frequent-flyer programs that reward customers for loyalty to one airline are an attempt to battle price comparisons and ease of switching.

An organization can also analyze the five forces within an industry prior to entry or as a basis for deciding to leave the industry. As a result of such an analysis, a firm may conclude that an industry is not attractive because of low entry barriers, powerful suppliers or buyers, close substitutes, or the number and strength of current competitors. In general, a thorough understanding of the forces within an industry can help a firm better understand the industry’s overall profit potential and those forces most likely to create opportunities and threats.

This completes our discussion of Porter’s model, which we used to consider the power of several important stakeholder groups. The next section provides ideas concerning how to manage external stakeholders.

### External Stakeholders and Environmental Uncertainty

In an effort to deal with the increasing complexity and competitiveness of the world economy, organizations are coming together in partnerships in increasing numbers. These partnerships come in many forms, such as joint ventures, consortia, and many types of informal alliances. Organizations interact with a large number of external stakeholders. One of the important strategic questions organizations face is deciding which stakeholders should become partners. Stakeholders that are high priority for partnerships are those that have a strong influence on the outcomes of the organization. For example, Toys ‘R’ Us will have a large influence on Mattel’s profits due to the large orders that it places. Or, a newly appointed, aggressive government regulator may be able to dramatically alter the way a firm will operate. These types of stakeholders powerfully influence the environmental uncertainty that an organization faces.

**Environmental uncertainty** reduces a firm’s ability to predict with confidence the future state of its environment, such as demand, competitor actions, new regulation, the cost of supplies, or the availability of labor. If the environment were highly predictable, the management task would be fairly simple and profits would be relatively easy to achieve. On the other hand, high levels of environmental uncertainty reduce an organization’s ability to chart an effective course into the future. From this perspective, stakeholders that (1) contribute to the environmental uncertainty facing a firm or (2) are able to reduce the environmental uncertainty facing a firm, should be given higher priority for partnerships. An example from the space industry demonstrates this point:
In the early ‘90s, Lockheed Space Operations Company (LSOC), a division of what is now Lockheed Martin, experienced a very high level of environmental uncertainty due to changes in the way the U.S. government was managing the space program. For years, the U.S. government had been putting increasing pressure on government agencies to reduce costs. Under one of its cost initiatives, the government decided that the many contracts associated with the space shuttle and rocket operations at Kennedy Space Center should be managed by one prime contractor.

Executives at LSOC, who were largely responsible for the space shuttle launch operations, were concerned that they might not win the bid to manage the Center due to the political clout of Rockwell. Rockwell had built the space shuttle and trained many of the astronauts who were now high-level government officials. To reduce the uncertainty associated with this situation, LSOC formed a joint venture with Rockwell to run the Kennedy Space Center. The joint venture, called United States Alliance (USA), was selected by the government from among several other contenders.

Partnering with External Stakeholders

Partnering tactics are not new. What is new is that they are being used with increasing frequency and with a broader base of stakeholders. Exhibit 2.3 contains some of the more traditional techniques for managing external stakeholders, as well as several examples of partnering strategies. The first column in Exhibit 2.3 lists a few traditional stakeholder management techniques, grouped by type of external stakeholder. These techniques are both common and essential, and they should be used where appropriate. Many of these techniques are intended to protect the organization from negative influences. However, recently the emphasis in stakeholder management has been shifting away from protecting the organization from the influence of external stakeholders toward treating stakeholders almost as if they are part of the internal organization (see the second column of Exhibit 2.3). The rest of this chapter presents a few examples that demonstrate how organizations can manage their task environments.

Efforts to partner with customers and suppliers often provide significant benefits. Many firms are involving strategically important customers and suppliers in product and process design, in quality training sessions, and in on-line production scheduling. For example, Digital Equipment Corporation (DEC) and Hewlett-Packard include suppliers on their product planning teams. DEC also asks managers to evaluate its suppliers as if they were part of the internal organization. G&F Industries, a plastic components manufacturer, has dedicated an employee to Bose, one of its major customers. The employee works full time inside the Bose facility.

To combat collapsing product and process life cycles and to get a jump on new emerging technologies, competitors also are joining forces in increasing numbers. Rival organizations are forming alliances for technological advancement, for new product development, to enter new or foreign markets, and to pursue a wide variety of other opportunities. For example, Goodyear and Michelin, the powerhouse tire makers, plan to join forces for a research and development operation and various other initiatives. Their agreement will involve sharing of licensed technologies, setting a common standard for run-flat tires (tires that run...
### Exhibit 2.3  Examples of Tactics for Managing and Partnering with External Stakeholders

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<thead>
<tr>
<th>Stakeholders</th>
<th>Traditional Management Tactics</th>
<th>Partnering Tactics</th>
</tr>
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<tbody>
<tr>
<td><strong>Customers</strong></td>
<td>Customer service departments&lt;br&gt;Marketing research&lt;br&gt;Advertising&lt;br&gt;On-site visits&lt;br&gt;Product/service development&lt;br&gt;Market development</td>
<td>Customer involvement on design teams&lt;br&gt;Customer involvement in product testing&lt;br&gt;Enhanced communication linkages&lt;br&gt;Joint training/service programs&lt;br&gt;Sharing of facilities&lt;br&gt;Appointments to board of directors</td>
</tr>
<tr>
<td><strong>Suppliers</strong></td>
<td>Purchasing departments&lt;br&gt;Encourage competition among suppliers&lt;br&gt;Sponsor new suppliers&lt;br&gt;Threat of vertical integration&lt;br&gt;Long-term contracts</td>
<td>Supplier involvement on design teams&lt;br&gt;Integration of ordering system with manufacturing&lt;br&gt;Shared information systems&lt;br&gt;Joint development of new products&lt;br&gt;Appointments to board of directors</td>
</tr>
<tr>
<td><strong>Competitors</strong></td>
<td>Competing on the basis of differentiation,&lt;br&gt;technology innovation, speed price cutting, market segmentation&lt;br&gt;Intelligence systems&lt;br&gt;Corporate spying and espionage*</td>
<td>Keiretsu*&lt;br&gt;Joint ventures for R&amp;D or market development&lt;br&gt;Collective lobbying efforts&lt;br&gt;Informal price leadership or collusion*&lt;br&gt;Mergers (horizontal integration)</td>
</tr>
<tr>
<td><strong>Government</strong></td>
<td>Legal/tax departments&lt;br&gt;Government relations departments&lt;br&gt;Lobbying/political action committees&lt;br&gt;Campaign contributions&lt;br&gt;Personal gifts to politicians*</td>
<td>Joint or government sponsored research&lt;br&gt;Joint ventures to work on social problems&lt;br&gt;Joint foreign development projects&lt;br&gt;Appointment of retired government officials to the board of directors</td>
</tr>
<tr>
<td><strong>Local Communities</strong></td>
<td>Community relations offices&lt;br&gt;Public relations advertising&lt;br&gt;Volunteerism in community service/politics&lt;br&gt;Donations to government/charities organizations&lt;br&gt;Gifts to local government officials*</td>
<td>Joint urban renewal programs&lt;br&gt;Cooperative training programs&lt;br&gt;Development committees/boards&lt;br&gt;Employment programs&lt;br&gt;Joint education programs</td>
</tr>
<tr>
<td><strong>Activist Groups</strong></td>
<td>Public/political relations efforts to offset or protect them from negative publicity&lt;br&gt;Financial donations</td>
<td>Consultation with members on sensitive issues&lt;br&gt;Joint ventures for research/research consortia&lt;br&gt;Appointment of group representatives to board</td>
</tr>
<tr>
<td><strong>Unions</strong></td>
<td>Avoid unions through high levels of employee satisfaction&lt;br&gt;Thwarting attempts to organize&lt;br&gt;Hiring of professional negotiators&lt;br&gt;Public relations advertising</td>
<td>Mutually satisfactory (win-win) labor contracts&lt;br&gt;Contract clauses that link pay to performance&lt;br&gt;Joint committees on safety and other issues&lt;br&gt;Lab leaders appointed to board of directors and included in major decisions</td>
</tr>
<tr>
<td><strong>Financial Intermediaries</strong></td>
<td>Financial reports/audits&lt;br&gt;Finance and accounting departments&lt;br&gt;High-level financial officer</td>
<td>Inclusion in decisions requiring financial backing&lt;br&gt;Appointments to the board of directors&lt;br&gt;Shared ownership of new projects</td>
</tr>
</tbody>
</table>

*These tactics are of questionable ethical acceptability to some internal and external stakeholders in the United States and elsewhere.
after the air is gone), and introduction of a jointly developed, integrated wheel and tire system. Rivals may also partner through a trade association, with the intention of pooling their resources to get the attention of potential customers, as is the case with the “Got Milk?” campaign.

In oligopolies, where a few major rivals dominate an industry, the major firms may cooperate with each other in setting prices. Formal price-setting cooperation is called collusion, and it is illegal in the United States and many other countries. However, firms may still cooperate informally by being careful not to drop prices enough to start a price war.

Organizations may form alliances with rivals in an effort to influence common stakeholders such as government agencies, activist groups, unions, or local communities. These alliances then become a part of the organization’s political strategy, which includes all organizational activities that have as one of their objectives the creation of a friendlier political climate for the organization. Lobbying is part of a political strategy, but it is only a small part of the bigger political picture. Collective activity may include membership in trade associations, chambers of commerce, and industry and labor panels. Firms join associations to gain access to information and to obtain legitimacy, acceptance, and influence. Finally, many organizations form alliances directly with government agencies and officials to pursue a wide variety of objectives, including basic research, finding answers to social problems, and establishing trade policies.

Although this section has focused primarily on stakeholders that are likely to be high priority, such as customers, suppliers, competitors, and government agencies and administrators, partnerships with some of the other stakeholders listed in Exhibit 2.3 have brought equally impressive results. For example, the New England Electric System (NEES) utility formed a partnership with the Conservation Law Foundation, a New England-based environmental organization, to deal with conservation, load management, and regulatory and rate adjustments. As a result of this collaboration, it is estimated that one-third of the planned power plants in the region will not have to be built until the year 2010, releasing this capital for other uses. New England Electric saved capital and the Conservation Law Foundation helped reduce, among other things, air pollution and respiratory problems in the affected areas. It was a win-win situation.

This chapter has discussed methods that firms can use to analyze and, to the extent possible, manage their external environments through partnerships and other strategies. The final section will present a tool that helps organizations understand the strategies of their competitors.

**STRATEGIC GROUPS**

In some industries, groups of competitors are constrained by similar resource positions and follow similar strategies. The groups or clusters of similar competitors are called strategic groups. For example, in the steel industry, domestic steel companies are of two general types: integrated continuous mills and mini-mills. Traditionally, the two groups of competitors faced very different cost structures and competed in largely different market segments. In recent years, the integrated mills have invested in mini-mill technology, and the mini-mill firms have developed new technologies to enter previously inaccessible market segments. Over time, the resource positions and strategies are converging, and the sharp differences between strategic groups are eroding.
One way to keep track of strategic groups and their behavior over time is with a strategic group map such as the one in Exhibit 2.4. A strategic group map is constructed by plotting industry rivals based on two or more strategic dimensions that are important to strategy in the industry. The axes of a strategic group map should describe strategy and not performance. Therefore, variables such as pricing strategy, customer service approach, level of advertising, and product mix are appropriate, whereas return-on-assets and earnings-per-share are not. Furthermore, to reveal more about the industry, the dimensions should not be highly correlated with one another. Members of the same strategic group should end up in the same general location on the map.

Strategic group maps can help an organization understand the strategies of competitors. They may also highlight an area in the industry in which no firms are presently competing (an opportunity). Another helpful use is in tracking the evolution of an industry over time. If movement from one group to another is difficult, then it is likely that mobility barriers exist. Mobility barriers are similar to entry barriers, but exist between strategic groups within one industry.

Exhibit 2.4 Strategic Group Map of Department Store and Specialty Retailing
This chapter dealt with the external environment, which consists of the broad and task environments. The following are key points from this discussion:

1. The most important elements in the broad environment, as it relates to a business organization and its task environment, are socio-cultural forces, global economic forces, technological forces, and global political/legal forces. Organizations use a variety of techniques, including brainstorming, scenario development, surveys, and expert opinion to forecast changes in this environment.

2. One important distinction between the task and broad environments is that the task environment is subject to a high level of organizational influence, whereas the broad environment is not.

3. The task environment includes external stakeholders such as customers, suppliers, competitors, government agencies and administrators, local communities, activist groups, unions, and financial intermediaries.

4. The five primary forces that determine the nature and level of competition in an industry include the strength of customers, the strength of suppliers, the availability of substitutes, the strength of entry barriers, and forces that determine the nature of existing competition.

5. Organizations should use partnering tactics to manage external stakeholders that have a large influence on the environmental uncertainty facing the organization. On the other hand, traditional monitoring techniques can be used to anticipate the needs of lower-priority stakeholders.

6. Important partnering tactics include joint ventures and other forms of strategic alliances, the establishment of mutually beneficial contracts, various forms of stakeholder involvement in organizational processes and decisions, and the development of political alliances to promote a favorable task environment.

7. Strategic group maps can help organizations understand the strategies of their competitors.

**END NOTES**


