

4.12: Common Frameworks for Evaluating the Business Environment

Learning Outcomes

- Explain environmental scanning and the PESTEL checklist for a company's general environment.
- Explain the impact of Porter's "five forces" on industry profits.
- Explain competitor analysis.



Starting a new business without evaluating the competitive environment is risky, indeed.

Introduction

The environment is always changing, and this is just as true for the business environment as it is for the physical world around us. Managers try to avoid being "taken by surprise" by unexpected events that would impact their organizations through an ongoing process called **environmental scanning**. Environmental scanning is a high-level, broad-based process of gathering, analyzing, and dispensing information for purpose of developing strategies or tactics. The process entails getting both factual data and qualitative opinions. Organizations also scan when they are considering whether to enter a particular industry.

PESTEL

Political	P
Economical	E
Social	S
Technological	T
Environmental	E
Legal	L

The PESTEL framework organizes information gathered from environmental scans.

You may wonder just how you go about analyzing the total external environment that would affect your company. A commonly used management tool is called PESTEL. PESTEL is an organizing framework that allows decision makers to understand and make connections with a mass of information. (You may sometimes see the name of this tool written as PESTLE or even just PEST in older sources.)

A PESTEL analysis examines six key macro-environmental factors in order to understand their interactions with the organization.

Besides alerting top management to potential threats in the environment, a PESTEL analysis is a part of the external strategic analysis when conducting research into new markets. It gives an overview of the different macro-environmental factors that the company has to take into consideration. Descriptions of the six key PESTEL factors follow.

Political

Political issues are a function of how much the government intrudes or is involved in an organization's operations. In particular, it looks at taxation and tariffs, regulations, political stability, and elections. For example, Google and other Internet providers have financial, legal, and ethical issues relating to operating in countries like China or Iran, where repressive governments want to control the flow of information. In another example, Google was slapped with a \$2.7 billion fine by the European Union for antitrust abuses (Google can appeal this decision with the European Court of Justice). Finally, the CEO of Apple is awaiting changes in the tax law before bringing almost \$250 billion in foreign reserves back to the United States. Often, decision makers for these organizations must choose between making money or suppressing information critical of the repressive regimes.

Economic

Economic factors start with indicators for the U.S. economy as a whole. These are growth, employment, inflation, and interest rates. Companies with foreign operations will worry about exchange rates. These factors are important in long-range forecasts for revenue and expenses. Businesses in the financial industry may pull back from aggressive strategies in times of rising interest rates.

Social

Society and culture have great impacts on the business environment. These factors include demographics like population growth, age distribution, and attitudes toward safety and health consciousness. For example, rising rates of obesity have forced management to look closely at marketing campaigns in giant food corporations such as Nestle and Kraft Foods.

Technological

Technology facts include research and development (R&D), automation and robotics, and technology incentives. The rate of technological change in the business environment is staggering. A term often paired with technology is *disruption*, a description for innovations that completely change the cast of leading competitors in an industry. Many organizations not only scan the technological environment but also monitor closely for new and disruptive processes. Walt Disney and Alphabet (Google's parent corporation) are both investing heavily to become leaders in virtual reality. They are betting billions that augmented reality will have the power to disrupt the gaming and entertainment industries.

Environmental

Weather, climate change, air quality, and natural disasters are all environmental factors. Some industries are especially at risk from changes in the natural environment, including manufacturing, agriculture, tourism and travel, and sports and entertainment. Many pollution regulations limiting water and air pollution have been passed that affect the operation of businesses. Today, the impact of climate control is being debated in Congress, and organizations in many industries are concerned how this latest environmental threat will affect their operations. Recently, Shell Oil spent more than \$7 billion exploring parts of the Arctic Circle for oil—a venture that was not possible before global warming increased drilling access in the area. They have since cancelled this initiative due to a lack of results, as well as strong international protests that it may cause further damage to an environmentally sensitive location.

Legal

Legal factors include discrimination laws, consumer protection laws, and employment, health, and safety policies. Antitrust, piracy and copyright laws, as well as immigration issues are also of growing importance in the business environment. All of these factors affect how organizations operate, their costs, and the demand for products. For example, after the collapse of Enron, the government passed the Sarbanes-Oxley Act in 2002. This legislation completely changed accounting and reporting requirements for corporations. These businesses have had to implement rigorous procedures to ensure compliance with the new regulations. After the Great Recession of 2008–2009, Congress passed the Dodd-Frank Act, which greatly increased regulations and oversight for banks and other financial firms. Bank lobbyists successfully slowed the implementation of many rules, but compliance costs doubled and totaled \$70 billion in 2016.

? Practice Question

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Porter's Five Forces

Michael Porter, a well-known business consultant and professor at Harvard University, identified five critical external factors that affect strategies being developed by organizations in any industry. This system, known as **Porter's Five Forces**, has become an important management strategy tool. Managers use the tool to examine opportunities and threats and to facilitate decision making in the context of their company's external environment. It measures the competitiveness of an industry and thus its *attractiveness* or potential profitability. An *unattractive* industry is one in which the combination of these five forces acts to drive down overall profitability.



The five forces defined by Porter include:

- **The threat of new entrants (or barriers to entry).** This refers to the threat that new competitors pose to the existing businesses in an industry. A profitable industry will attract new competitors. If it is easy for new businesses to enter the industry, then the businesses already operating in the industry are at a greater risk. There may be a high threat of new entrants to an industry when brand names are not well-known, when it is easy for customers to switch to a new supplier, and when trademarks or copyrights are not involved in the production process. For example, it would be very hard to enter an industry such as airlines, which requires a huge financial investment to pay for equipment, personnel, and airport gateways.
- **The threat of substitute products or services.** A substitute product is not a similar product from a competitor, but rather a different product or service altogether but that performs the same purpose in the mind of the consumer. For example, a city subway system could be a substitute product to an automobile manufacturer. Likewise, e-mails may substitute for writing letters, olive oil may be a butter substitute, and tea may substitute for coffee. If there are good substitutes to a product, the industry is less profitable.
- **Competitive rivalry within the industry.** Porter believes that the intensity or the level of competition in an industry is one of the main forces that determines the profitability of that industry. A highly competitive market suggests that the competitors are aggressively trying to take market share from their rivals. Intensity can be affected by the number of competitors, the size of the market, the growth of the industry, and how difficult it is to differentiate your product (make it unique in some major feature). The airline and automotive industries are examples of high rivalry industries.
- **The bargaining power of buyers.** Buyer bargaining power refers to the amount of pressure customers can put on a seller. The buyer wants to lower prices, increase service, or improve the quality of the product. From the viewpoint of the seller, an industry where the buyer has high bargaining power is not particularly attractive because competitors will have many possible strategies for easily taking the customer away. High buying bargaining power decreases potential profits if the seller responds to the buyers' tactics. Remember that the buyer is not always a consumer; many businesses sell to other businesses who also have buyer bargaining power. A company like Walmart has a lot of buyer bargaining power because of the extremely high volume of its purchases.

- **The bargaining power of suppliers.** Supplier bargaining power is another force that shapes the competitive measure of an industry because it limits the ability of the seller to make a profit. Powerful suppliers can pressure buyers by raising prices, lowering quality, or reducing the availability of the supply.

An important thing to remember about Porter's Five Forces is that it is useful at an industry level and not for groups or segments of a market. It is also a "snapshot" of what the industry looks like at a particular time and needs to be updated regularly. And as with any management tool, it is not perfect and infallible. When considered as a starting point for discussion and further investigation, however, Porter's Five Forces is very useful.

? Practice Question

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Competitive Analysis

Earlier in this module, you read about the concept of competitive advantage. You learned that knowing the strengths and weaknesses of your competitors are key elements in devising organizational goals and determining strategies to meet the goals.

Once the external business environment has been analyzed for its suitability, industry competitors must be profiled to determine who your specific competitors are. Not all "players" in an industry will be in direct competition with your organization. (You don't want to spend valuable resources on an in-depth competitive analysis of BMW and Mercedes if you sell Hyundais.) A robust competitive analysis will allow you to focus on those companies that will compete for customers in your target market.

A competitive analysis looks at competitors and tries to answer such questions as these in the following categories:

- **General Background:** Who are my competitors? Where are they located? Who are the key personalities? What type of organizational structure is it?
- **Financial:** How profitable are they? Have they grown in the recent past? And any other data you can ethically discover.
- **Products:** What products do they sell? Have they introduced new products and what is their success rate? What brands do they carry? Do they hold patents and licenses?
- **Customers:** What market segment do they serve? What is the customer growth rate? How strong is the customer loyalty?
- **Advertising and Sales:** What are their distribution channels? What is their promotional strategy? How large is their sales force? What is their pricing and discount structure?
- **Personnel:** How many employees do they have? What is their compensation package including benefits? What kind of managers and what management style do they show? More importantly, what skills is the competition hiring? If a company is hiring experts in artificial intelligence, it tells the competition quite a bit about the plans for the future.

There are many more questions that would be relevant to this kind of in-depth analysis. The more you know about your competition, the better prepared you will be when you go up against it. The next section will identify industry components that affect your ability to operate. It will introduce tools that allow organizations to focus on only the specific internal and external features that affect them.

? Practice Question

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