CHAPTER 2

The External Environment

The essence of a business is outside itself.

—Peter Drucker

CHAPTER OUTLINE

A Look Ahead
The Macroenvironment
  Law and Regulations
  The Economy
  Technology
  Demographics
  Social Issues and the Natural Environment
The Competitive Environment
  Competitors
  Threat of New Entrants
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  Suppliers
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Environmental Analysis
  Environmental Scanning
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Responding to the Environment
  Adapting to the Environment: Changing Yourself
  Influencing Your Environment
  Changing the Environment You Are In
Choosing a Response Approach

LEARNING OBJECTIVES

After studying Chapter 2, you will know:

1. How environmental forces influence organizations, as well as how organizations can influence their environments.

2. How to make a distinction between the macroenvironment and the competitive environment.

3. Why organizations should attend to economic and social developments in the international environment.

4. How to analyze the competitive environment.

5. How organizations respond to environmental uncertainty.
TELECOMS FACE EXTERNAL PRESSURES

While there was plenty of blame to go around after the dot-com meltdown in the early 2000s, from poor strategy to corporate greed, another factor played a role in the failure of many firms: government regulations. A lawyer for Global Crossing, which filed for bankruptcy after falling from its exalted position as one of the top-earning telecom firms, likened the fees demanded by all levels of government to robbery, saying, “They’re being held up.”

Local, state, and government agencies demanded excessive fees or free services from firms before granting them rights-of-way for cables. Moreover, breaking through the red tape sometimes took years before access was approved as the firms’ requests worked their way through bureaucracies and legal hurdles. The results for consumers were delays in service, limited providers, and higher prices when the excessive fees were passed on to them.

For example, although Global Crossing had been told that it needed only a routine permit to finish its trans-Pacific fiber-optic cable over the final 60 miles to Seattle, the federal National Oceanic and Atmospheric Administration (NOAA) then required $5 million from the firm as a fee for laying the cable within a federal marine sanctuary. The permit fees included $3.9 million to monitor the effects of the cable on the sanctuary’s starfish, coral, sponges, and other sea life over 10 years and $500,000 to finance a visitors-center exhibit about the ocean floor. A separate $7.2 million easement fee was charged by NOAA for the fair market value of the ocean property easement.

Other telecom participants, such as phone providers, complain that the cable systems receive exclusive franchises while they must compete with each other (as well as with the cable systems). Government agencies are allowed by law to seek only “fair and reasonable compensation” for rights-of-way, which the agencies feel means the equivalent of market rents, while the firms feel they should not have to pay for more than the impact of their work. “If we cut up the street, we believe we should have to restore it, but when we see fees based on my gross operating revenues, I have a problem tying that to the city’s costs,” says Williams Communications’s Rick Wolfe.

Here are some examples of the barriers faced by telecom firms:

- **High fees.** For the right to run wires in White Plains, New York, to provide fast data services to businesses, AT&T was asked to pay 5 percent not only of the local phone-service revenue but also of long-distance, wireless, and cable-service income from the town. Eugene, Oregon, charges 9 percent of basic phone revenue.

- **Demands for free service.** When Williams wanted to lay 10 miles of cable along Maryland highways, that state’s department of transportation required Williams to provide free fiber-optic cable that monitors the temperature of state roads and links computers so that citizens can apply for state licenses online, in addition to $780,000 a year in right-of-way fees.
• **Red tape.** When Qwest installed less than a mile of wire for broadband service for its one business customer, Berkeley, California, the city charged it for excessive information, such as business plans, application fees, and underground maps, which Qwest called “intrusive and a tremendous amount of work.” (A court struck down many of the paperwork rules.)

• **Delays.** After 10 months of repeatedly contacting Shreveport, Louisiana, as it tried to finalize a franchise, Adelphia dropped its plans. Culver City, California, forced Adelphia, Level 3 Communications, and Metromedia Fiber Network to wait nearly two years while it debated a right-of-way ordinance.

Federal Communications Commission Chairman Michael Powell noted his agency’s “growing concern about rights-of-way as a barrier.” Texas, Florida, Michigan, and Kansas recently limited the fees cities can charge, and a bill has been introduced in Congress to curb the right-of-way fees levied by federal agencies such as NOAA.


Besides problems of their own making, telecom firms were beset by government fees and restrictions—factors of the external environment—that affected their ability to compete effectively. This chapter discusses how pressures from outside organizations create the external context in which organizations operate.

As you learned in the first chapter, organizations are open systems that are affected by, and in turn affect, their external environments. By **external environment**, we mean all relevant forces outside the organization’s boundaries. By **relevant**, we mean factors to which managers must pay attention to help their organizations compete effectively and survive.

Many of these factors are uncontrollable. Companies large and small are buffeted or battered by recession, government interference, competitors’ actions, and so forth. But their lack of control does not mean that managers can ignore such forces, use them as excuses for poor performance, and try to just get by. Managers must stay abreast of external developments and react accordingly. Moreover, as we will discuss later in this chapter, it sometimes is possible to influence components of the external environment. We will examine ways in which organizations can do just that.

Figure 2.1 shows the external environment of a firm. The firm exists in its **competitive environment**, which is composed of the firm and competitors, suppliers, customers, new entrants, and substitutes. At the more general level is the **macroenvironment**, which includes legal, political, economic, technological, demographic, and social and natural factors that generally affect all organizations.

**A Look Ahead**

This chapter discusses the basic characteristics of an organization’s environment and the importance of that environment for strategic management. Later chapters will elaborate on many of the basic environmental forces introduced here. For example, technology will be discussed again in Chapter 17. The global environment gets a thorough treatment in Chapter 6, which is devoted entirely to international management. Other chapters focus on ethics, social responsibility, and the natural environment. Chapter 18 reiterates the theme that recurs throughout this text: Organizations must change continually because environments change continually.
All organizations operate in a macroenvironment, which is defined by the most general elements in the external environment that potentially can influence strategic decisions. Although a top executive team may have unique internal strengths and ideas about its goals, it must consider external factors before taking action.

**Laws and Regulations**

U.S. government policies both impose strategic constraints and provide opportunities. The government can affect business opportunities through tax laws, economic policies, and international trade rulings. An example of restraint on business action is the U.S. government’s standards regarding bribery. In some countries, bribes and kickbacks are common and expected ways of doing business, but for U.S. firms these are illegal practices. Indeed, some U.S. businesses have been fined for using bribery when competing internationally.

*Regulators* are specific government organizations in a firm’s more immediate task environment. Regulatory agencies such as the Occupational Safety and Health Administration (OSHA), the Interstate Commerce Commission (ICC), the Federal Aviation Administration (FAA), the Equal Employment Opportunity Commission (EEOC), the National Labor Relations Board (NLRB), the Office of Federal Contract Compliance Programs (OFCCP), and the Environmental Protection Agency (EPA) have the power to investigate company practices and take legal action to ensure compliance with the laws.
For example, the Securities and Exchange Commission (SEC) regulates U.S. financial markets; since the insider-trading scandals, the SEC has changed investment houses’ policies and practices dramatically. And the Food and Drug Administration (FDA) can prevent a company from selling an unsafe or ineffective product to the public.

Publicly traded pharmaceutical firms, for example, face regulation both from the FDA and from the SEC. When the FDA declined to review IMClone’s application for the approval of Erbitux, a new cancer-fighting drug, the firm’s stock price plummeted and the SEC opened an investigation into whether the firm misled investors and was involved in insider trading. Bristol-Myers Squibb, which had invested $2 billion for a 20 percent stake in IMClone Systems, lost $875 million and faced a separate SEC investigation into its accounting practices.

The Economy

Although most Americans are used to thinking in terms of the U.S. economy, the economic environment is created by complex interconnections among the economies of different countries. Wall Street investment analysts begin their workday thinking not just about what the Dow Jones did yesterday but also about how the London and Tokyo exchanges did overnight. Growth and recessions occur worldwide as well as domestically.

The economic environment dramatically affects companies’ ability to function effectively and influences their strategic choices. Interest and inflation rates affect the availability and cost of capital, the ability to expand, prices, costs, and consumer demand for products. Unemployment rates affect labor availability and the wages the firm must pay, as well as product demand.

An important economic influence has centered on the stock market. Individuals and institutions looking for good returns had invested in promising companies, including start-ups and dot-coms. When technology-based firms during the 1990s provided better than 20 percent returns to investors, more individuals entered the capital markets (Figure 2.2). With the slide in technology stocks and the mistrust of corporate accounting, the returns fell to negative numbers in the early 2000s, although other economic indicators remained strong.

Economic conditions change over time and are difficult to predict. Bull and bear markets come and go. Periods of dramatic growth may be followed by a recession. Every trend undoubtedly will end—but when? Even when times seem good, budget deficits or other considerations create concern about the future.

Technology

Today a company cannot succeed without incorporating into its strategy the astonishing technologies that exist and continue to evolve. Technological advances create new products, advanced production techniques, and better ways of managing and communicating.
In addition, as technology evolves, new industries, markets, and competitive niches develop. For example, the advent of computers created a huge industry. Early entrants in biotechnology are trying to establish dominant positions, while later entrants work on technological advances that will give them a competitive niche.

New technologies also provide new production techniques. In manufacturing, sophisticated robots perform jobs without suffering fatigue, requiring vacations or weekends off, or demanding wage increases. Until the U.S. steel industry began modernizing its plants, its productivity lagged far behind that of the technologically superior Japanese plants.

New technologies also provide new ways to manage and communicate. Computerized management information systems (MIS) make information available when needed. Computers monitor productivity and note performance deficiencies. Telecommunications allow conferences to take place without requiring people to travel to the same location. Consider the following discussion of changes in the field of retail sporting goods. As you can see, technological advances create innovations in business. Strategies developed around the cutting edge of technological advances create a competitive advantage; strategies that ignore or lag behind competitors in considering technology lead to obsolescence and extinction. This issue is so important that we devote an entire chapter (Chapter 17) to the topic.

As Lance Armstrong tackles the French Alps, he’s measuring his ascent with the help of an engineering marvel from Nike and the Japanese watchmaker Seiko: an altimeter built into a titanium-coated wristwatch. Armstrong’s eyes are protected by sunglasses from Oakley that are precision molded to thousandths of an inch for aerodynamic efficiency and equipped with optical lenses so clear that a laser beam can pass through them without noticeable defraction. Under Armstrong’s body floats a superstrong carbon fiber-epoxy bicycle frame built to cut the wind with teardrop-shaped tubing and weighing in at a pixiesque 2.27 pounds.

Mirroring changes in the manufacturing and aerospace industries over the past decade, cycling has experienced a rapid evolution from gut check to geek tech. Computerized engineering and materials science have influenced the design of everything from pedals, to shoes, to gear assemblies. In sports ranging from golf and tennis to sailing and softball, sports-equipment companies increasingly apply space-age techniques they once reserved for the pros to everyday products. It’s all part of a mad scramble to win customers and improve margins in a sports-equipment market that totaled $65 billion in 2001 in the United States alone.

As computer power soared and prices sank, three dimensional (3-D) modeling quickly got cheap. A select group of sporting-goods companies took notice. Most were in areas where athletes rely heavily on technology, such as golf, cycling, tennis, and running. As they incorporated 3-D modeling into design and production, those firms found that they were able to tweak designs to unprecedented tolerances. “We’re moving a nose piece a hundredth of an inch back and forth to make sure it looks the best. It’s pretty obsessive,” says Oakley’s president, Colin Baden. The Foothill Ranch (California) company produces not only sunglasses but also wristwatches and apparel.

Computerized design also spawned a generation of machines that use digital coordinates to generate precision scale models in light-reactive plastics or wax, and those machines can receive commands from any place around the globe. Engineers could go from concept drawings to prototypes in hours, not days. Sporting-goods companies with serious design shops either own such a device or use one regularly. Oakley’s Baden can input design parameters into his prototype machine in the morning, have resin sunglass models by noon, pop in premade lenses, and have mountain bikers and skiers test the models and provide feedback by 5 p.m. Nike’s Boyd notes that this quick cycle is particularly important in sports where ergonomic factors are crucial to a product’s sales potential.
More powerful computers also have given designers the ability to simulate stress tests virtually. That in turn has encouraged designers to try using newer materials in their products, since they no longer have to worry about overengineering the entire package to compensate for unknown stress patterns. “If we find a material process that might have been used to make taillights for cars but think it would have a great application in a new category like watches, we would be in the forefront of trying to use that no matter what the disastrous consequences might be,” says Oakley’s Baden.

The design and manufacturing advances boost the companies’ bottom lines. While it’s hard to quantify the precise savings, most outfits claim that they cut costs with computers by reducing staffing, pushing products to market faster, and eliminating mistakes earlier in the design and concept stages. In the early 1990s Oakley introduced two or three new sunglass frames per year. In 2001 it introduced 11.

Greater product variety has helped generate steadily growing sales (higher by 18 percent in 2001). “If we can apply the latest in technology in our manufacturing efforts, we tend to gain substantially in our margins,” says Baden. Boosting margins, as well as stoking demand with innovative products, has become an imperative in the sector, especially in the current rocky economy. According to the sports-market researcher SGMA International, U.S. manufacturers’ sales of sports equipment, apparel, footwear, and recreational vehicles, watercraft, and bicycles to wholesalers fell by 1.8 percent in 2001, declining to $65 billion from $66.1 billion in 2000. In certain products, such as cycling, sales declined by double digits. Slackening demand increases the pressure on sporting-goods companies to cut costs further, and this probably means that even more will turn to computer-aided design and manufacturing.

So far the majority of sports outfits, most of which design simple products, remain largely in the Dark Ages when it comes to using advanced computer techniques. “Some of them are older industries. They haven’t broken into a lot of the new materials and design processes. We see a lot of opportunities there,” says Brian Vogel, president of the Somerville, Massachusetts, product-design firm Altitude. More businesses could quickly make the switch once the benefits become clearer and as companies start to understand how accessible these new technologies are. Most design software today costs less than $10,000. And Boyd regularly runs his programs on his laptop; he even designed a new sports CD player for Nike on a flight to Hong Kong. All this goes to show that cutting-edge companies such as Nike and Oakley continue to forge ahead faster than Lance Armstrong on his finish-line kick along the Champs Elysées.

approximately 158 million. Fluctuations in the birthrate influence population trends somewhat. In past years, the number of younger workers (16 to 24 years of age) has declined, but now that children of the baby-boom generation are entering the workforce, this age group is expected to grow 16.8 percent by 2010. At the same time, baby boomers themselves are reaching retirement age, and so the number of older workers (55 and above) will rise to about 15 percent of the labor force. Eventually, declining participation in work of older persons will largely offset the increase in the number of persons in this population group.

Immigration is also a factor that significantly influences the U.S. population and labor force. Over the last decade immigrants have accounted for approximately 40 percent of the U.S. population growth, a trend that has an important impact on the labor force. Immigrants are frequently of working age but have different educational and occupational backgrounds from the rest of the labor force. By 2010, the labor force will be even more diverse than it is today. White males will constitute approximately 39 percent of the labor force, African-Americans 13 percent, Hispanics 13 percent, and Asians and others 6 percent.

Women continue to join the U.S. labor force in record numbers. In 1970, women made up only about one-third of the labor force. By 2010 women are expected to account for over 51.9 percent, a trend that provides companies with more talent from which to choose. A more diverse workforce has its advantages, but managers have to make certain they provide equality for women and minorities with respect to employment, advancement opportunities, and compensation. Strategic plans must be made for recruiting, retaining, training, motivating, and effectively utilizing people of diverse demographic backgrounds with the skills needed to achieve the company’s mission.

Social Issues and the Natural Environment

Societal trends regarding how people think and behave have major implications for management of the labor force, corporate social actions, and strategic decisions about products and markets.

During the 1980s and 1990s women in the workforce often chose to delay having children as they focused on their careers, but today more working women are having children and then returning to the workforce. As a result, companies have introduced more supportive policies, including family leave, flexible working hours, and child care assistance. Many firms also extend these benefits to all employees or allow them to design their own benefits packages, where they can choose from a menu of available benefits that suit their individual situations. Domestic partners, whether they are in a marital relationship or not, also are covered by many employee benefit programs. Firms provide these benefits as a way of increasing a source of competitive advantage: an experienced workforce.

A prominent issue today pertains to natural resources: drilling for oil in formerly protected areas in the United States. Firms in the oil industry face considerable public opinion both in favor of preserving the natural environment, and against the country’s dependence on other countries for fuel. Automakers face similar concerns about air quality as they strive to create more fuel-efficient cars. The protection of the natural environment is so important to managerial decision that we devote Appendix C following Chapter 5 to it.
All organizations are affected by the general components of the macroenvironment we have just discussed. Each organization also functions in a closer, more immediate competitive environment. The competitive environment includes the specific organizations with which the organization interacts. As shown in Figure 2.3, the competitive environment includes rivalry among current competitors, threat of new entrants, threat of substitutes, power of suppliers, and power of customers. This model was originally developed by Michael Porter, a Harvard professor and a noted authority on strategic management. According to Porter, successful managers do more than simply react to the environment; they act in ways that actually shape or change the organization's environment. In strategic decision making, Porter's model is an excellent method for analyzing the competitive environment in order to adapt to or influence the nature of competition.

**Competitors**

Among the various components of the competitive environment, competitors within the industry must first deal with one another. When organizations compete for the same customers and try to win market share at the others’ expense, all must react to and anticipate their competitors' actions.

The first question to consider is: Who is the competition? Sometimes answers are obvious. Coca-Cola and PepsiCo are competitors, as are the Big Three automakers: General Motors, Ford, and DaimlerChrysler. But sometimes organizations focus too exclusively on traditional rivalries and miss the emerging ones. Historically, Sears & Roebuck focused on its competition with J.C. Penney. However, Sears’ real competitors are Kmart and Wal-Mart at the low end; Target in the middle; Nordstrom at the high end; and a variety of catalogers, such as L.L. Bean, and Eddie Bauer. Similarly, United Airlines, Delta, American, and U.S.Airways have focused their attention on a battle over long haul and international routes. In the process, they all but ignored smaller carriers such as Southwest, Alaska Air, and Jet Blue that have grown and succeeded in regional markets.

Thus, as a first step in understanding their competitive environment, organizations must identify their competitors. Competitors may include (1) small domestic firms, especially their entry into tiny, premium markets; (2) overseas firms, especially their efforts to solidify positions in small niches (a traditional Japanese tactic); (3) big, new domestic companies exploring new markets; (4) strong regional competitors; and (5) unusual entries such as Internet shopping.
Once competitors have been identified, the next step is to analyze how they compete. Competitors use tactics such as price reductions, new-product introductions, and advertising campaigns to gain advantage over their rivals. It is essential to understand what competitors are doing when you are honing your own strategy. Competition is most intense when there are many direct competitors (including foreign contenders), when industry growth is slow, and when the product or service cannot be differentiated in some way.

New, high-growth industries offer enormous opportunities for profits. When an industry matures and growth slows, profits drop. Then, intense competition causes an industry shakeout: Weaker companies are eliminated, and the strong companies survive.\(^6\)

### Threat of New Entrants

New entrants into an industry compete with established companies. If many factors prevent new companies from entering the industry, the threat to established firms is less serious. If there are few such **barriers to entry**, the threat of new entrants is more serious. Some major barriers to entry are government policy, capital requirements, brand identification, cost disadvantages, and distribution channels. The government can limit or prevent entry, as occurs when the FDA forbids a new drug entrant. Some industries, such as trucking and liquor retailing, are regulated; more subtle government controls operate in fields such as mining and ski area development. Patents are also entry barriers. When a patent expires, other companies can then enter the market. For example, when the pharmaceutical firm Eli Lilly and Co.’s patent on its antidepressant drug Prozac expired, it lost its U.S. monopoly on the drug and its sales plunged. Barr Laboratories Inc. won the right to be the exclusive seller of a generic version of Prozac for six months. After that period other copycats flooded the market, eroding Barr’s sales of the drug.

Other barriers are less formal but can have the same effect. Capital requirements may be so high that companies won’t risk or try to raise such large amounts of money. Brand identification forces new entrants to spend heavily to overcome customer loyalty. The cost advantages established companies hold—due to large size, favorable locations, existing assets, and so forth—also can be formidable entry barriers.

Finally, existing competitors may have such tight distribution channels that new entrants have difficulty getting their products or services to customers. For example, established food products already have supermarket shelf space. New entrants must displace existing products with promotions, price breaks, intensive selling, and other tactics.

### Threat of Substitutes

Technological advances and economic efficiencies are among the ways that firms can develop substitutes for existing products. For example, although Southwest Airlines has developed strong rivalries with other airlines, it also competes—as a substitute—with bus companies such as Greyhound and rental car companies such as Avis. Southwest has gotten its cost base down to such a low point that it is now cheaper to fly from Los Angeles to Phoenix than it is to take a bus or rent a car. This particular example shows that substitute products or services can limit another industry’s revenue potential. Companies in those industries are likely to suffer growth and earnings problems unless they improve quality or launch aggressive marketing campaigns.\(^7\)

In addition to current substitutes, companies need to think about potential substitutes that may be viable in the near future. For example, as alternatives to fossil fuels, experts suggest that nuclear fusion, solar power, and wind energy may prove useful one day. The advantages promised by each of these technologies are many: inexhaustible fuel supplies, electricity “too cheap to meter,” zero emissions, universal public acceptance, and so on. Yet while they may look good on paper (and give us a warm, fuzzy feeling inside), they often come up short in terms of economics and/or technical viability. Table 2.1 shows a list of products and potential substitutes.\(^8\)
Recall from our discussion of open systems that organizations must acquire resources from their environment and convert those resources into products or services to sell. Suppliers provide the resources needed for production and may come in the form of people (supplied by trade schools and universities), raw materials (supplied by producers, wholesalers, and distributors), information (supplied by researchers and consulting firms), and financial capital (supplied by banks and other sources). But suppliers are important to an organization for reasons that go beyond the resources they provide. Suppliers can raise their prices or provide poor-quality goods and services. Labor unions can go on strike or demand higher wages. Workers may produce defective work. Powerful suppliers, then, can reduce an organization’s profits, particularly if the organization cannot pass on price increases to its customers.

### Suppliers

Recall from our discussion of open systems that organizations must acquire resources from their environment and convert those resources into products or services to sell. Suppliers provide the resources needed for production and may come in the form of people (supplied by trade schools and universities), raw materials (supplied by producers, wholesalers, and distributors), information (supplied by researchers and consulting firms), and financial capital (supplied by banks and other sources). But suppliers are important to an organization for reasons that go beyond the resources they provide. Suppliers can raise their prices or provide poor-quality goods and services. Labor unions can go on strike or demand higher wages. Workers may produce defective work. Powerful suppliers, then, can reduce an organization’s profits, particularly if the organization cannot pass on price increases to its customers.

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<tr>
<th>If the Product Is . . .</th>
<th>The Substitute Might Be . . .</th>
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<tbody>
<tr>
<td>Cotton</td>
<td>Polyester</td>
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<td>Coffee</td>
<td>Soft drinks</td>
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<td>Fossil fuels</td>
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<td>Home video/DVD</td>
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<td>Radio/MP3</td>
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<td>Train, bus, bicycle</td>
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<td>Nutrasweet</td>
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<td>House</td>
<td>Apartment, condo, mobile home</td>
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<td>Aluminum siding</td>
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<td>Trashy magazine</td>
<td>Internet</td>
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<td>Local telephone</td>
<td>Cellular phone, pager</td>
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### TABLE 2.1

Potential Substitutes for Products

The summer of 2002 saw yet another threat of a baseball strike—the 9th since 1972—by the major league baseball union.
One particularly noteworthy set of suppliers to some industries is the international labor unions. Although unionization in the United States has dropped to about 10 percent of the private labor force, labor unions are still particularly powerful in industries such as steel, autos, and transportation. Even the Screen Actors Guild, the union representing workers in the entertainment industry, exerts considerable power on behalf of its members. For example, Tiger Woods was fined $100,000 for making a nonunion Buick commercial during a strike by the American Federation of Television and Radio Artists. Labor unions represent and protect the interests of their members with respect to hiring, wages, working conditions, job security, and due process appeals. Historically, the relationship between management and labor unions has been adversarial; however, both sides seem to realize that to increase productivity and competitiveness, management and labor must work together in collaborative relationships. Troubled labor relations can create higher costs and productivity declines and eventually lead to layoffs.9

Web technology has had a major impact on the way organizations connect with their suppliers. In many industries, firms have established Internet procurement portals for online auctioning. These auctions can be for purchases that range from cleaning supplies to security systems to office furniture—you name it. The portals themselves are set up as Internet firms and typically are established as joint ventures among partners. The belief is that online auctions will streamline business-to-business (B2B) transactions and make the whole purchasing process more efficient. Here is just a sample:

Automotive: The Big Three automakers—DaimlerChrysler, Ford, and General Motors—pooled the $240 billion they spend each year on parts to team up on an online supplies exchange. That marketplace was expected to involve annual transactions totaling more than $300 billion. The new company now has a name, Covisint (go to www.covisint.com to find out what it means), and the initiative has added Nissan, Renault, Commerce One, Oracle, and PSA Peugeot Citroen. Covisint has headquarters in Amsterdam, Tokyo, and Southfield, Michigan, as well as offices in Frankfurt, Paris, and Brazil.

Computers: E2open was formed in 2000 as a platform where computing, networking, and consumer electronics equipment industries can implement new ways to communicate, coordinate, and collaborate in a manner that increases efficiencies and profits for all. The founders included leaders Acer, Hitachi, IBM, LG Electronics, Lucent Technologies, Matsushita Electric (Panasonic), Nortel Networks, Seagate Technology, Solectron, and Toshiba.

Retail: GlobalNetXchange (GNX) is a B2B retail marketplace set up by Sears Roebuck, French retailer Carrefour, Kroger, and several others (including software company Oracle). Since its inception, the members of GNX have conducted over 5500 auctions valued at more than $US 4.1 billion. One competitor is WorldWide Retail Exchange, an online auction established by 22 of the world’s largest retailers, such as Royal Ahold and Target. Wal-Mart has its own online marketplace that it uses for supplier auctioning; Wal-Mart buys and sells twice as many goods as Sears and Carrefour combined.

Consumer goods: Transora.com is an online supplier exchange established by 49 consumer-goods makers, including Procter & Gamble, Sara Lee, and Coca-Cola.

Oil: More than 240 companies use Altra Energy Technology’s online services to buy, sell, and transport products such as natural gas, fuels, and electricity.

Will it work? There are still some questions that need to be answered. Altra is the first (and only) profitable exchange. Governance remains a prickly issue for many of these exchanges. Can member companies, which usually are competitors, truly cooperate and allow an independent management team to lead the joint venture? Suppliers are often reluctant to participate. Already many of the industry-led marketplaces have retained Big Five consulting firms to help oversee negotiations during the start-up phase. Yet the future looks promising: Unlike some risky Net start-ups, there is good reason to believe these
Organizations are at a disadvantage if they become overly dependent on any powerful supplier. A supplier is powerful if the buyer has few other sources of supply or if the supplier has many other buyers. For example, if computer companies can go only to Microsoft for software or only to Intel for microchips, those suppliers can exert a great deal of pressure. In many cases, companies build up switching costs. Switching costs are fixed costs buyers face if they change suppliers. For example, once a buyer learns how to operate a supplier's equipment, such as computer software, the buyer faces both economic and psychological costs in changing to a new supplier.10

Choosing the right supplier is an important strategic decision. Suppliers can affect manufacturing time, product quality, and inventory levels. The relationship between suppliers and the organization is changing in some companies. The close supplier relationship has become a new model for many organizations, such as Ford Motor, that are using a just-in-time manufacturing approach (discussed in Chapters 16 and 17).

Customers

Customers purchase the products or services an organization offers. Without customers, a company won’t survive. You are a final consumer when you buy a McDonald’s hamburger or a pair of jeans from a retailer at the mall. Intermediate consumers buy raw materials or wholesale products and then sell to final consumers. Intermediate customers actually make more purchases than individual final consumers do. Examples of intermediate customers include retailers, who buy clothes from wholesalers and manufacturers’ representatives before selling them to their customers, and industrial buyers, who buy raw materials (such as chemicals) before converting them into final products.

Like suppliers, customers are important to organizations for reasons other than the money they provide for goods and services. Customers can demand lower prices, higher quality, unique product specifications, or better service. They also can play competitors against one another, as occurs when a car customer (or a purchasing agent) collects different offers and negotiates for the best price.

Customer service means giving customers what they want or need, the way they want it, the first time. This usually depends on the speed and dependability with which an organization can deliver its products or services. Actions and attitudes that mean excellent customer service include the following:

- Speed of filling and delivering normal orders.
- Willingness to meet emergency needs.
- Merchandise delivered in good condition.
- Readiness to take back defective goods and resupply quickly.
In all businesses—services as well as manufacturing—strategies that emphasize good customer service provide a critical competitive advantage. The organization is at a disadvantage if it depends too heavily on powerful customers. Customers are powerful if they make large purchases or if they can easily find alternative places to buy. If you are the largest customer of a firm and there are other firms from which you can buy, you have power over that firm, and you are likely to be able to negotiate with it successfully. Your firm’s biggest customers—especially if they can buy from other sources—will have the greatest negotiating power over you. Customer relationship management is discussed more fully in Chapter 9.

If managers do not understand how the environment affects their organizations or cannot identify opportunities and threats that are likely to be important, their ability to make decisions and execute plans will be severely limited. For example, if little is known about customer likes and dislikes, organizations will have a difficult time designing new products, scheduling production, developing marketing plans, and the like. In short, timely and accurate environmental information is critical for running a business.

But information about the environment is not always readily available. Environmental uncertainty means that managers do not have enough information about the environment to understand or predict the future. Uncertainty arises from two related factors: (1) complexity and (2) dynamism. Environmental complexity refers to the number of issues to which a manager must attend as well as their interconnectedness. For example, industries that have many different firms that compete in vastly different ways tend to be more complex—and uncertain—than industries with only a few key competitors. Similarly, environmental dynamism refers to the degree of discontinuous change that occurs within the industry. For example, high-growth industries with products and technologies that change rapidly tend to be more uncertain than stable industries where change is less dramatic and more predictable.

As environmental uncertainty increases, managers must develop techniques and methods for collecting, sorting through, and interpreting information about the environment. By analyzing environmental forces—in both the macroenvironment and the competitive environment—managers can identify opportunities and threats that might affect the organization.

**Environmental Scanning**

Perhaps the first step in coping with uncertainty in the environment is pinning down what might be of importance. It is frequently the case that organizations (and individuals) act out of ignorance, only to regret those actions in the future. IBM, for example, had the opportunity to purchase the technology behind xerography but turned it down. Xerox saw the potential, and the rest is history. However, Xerox researchers later developed the technology for the original computer mouse, but not seeing the potential, the company missed an important market opportunity.

To understand and predict changes, opportunities, and threats, organizations such as Monsanto, Weyerhaeuser, and Union Carbide spend a good deal of time and money monitoring events in the environment. Environmental scanning means both searching out information...
that is unavailable to most people and sorting through that information to interpret what is important and what is not. Managers can ask questions such as:

- Who are our current competitors?
- Are there few or many entry barriers to our industry?
- What substitutes exist for our product or service?
- Is the company too dependent on powerful suppliers?
- Is the company too dependent on powerful customers?13

Answers to these questions help managers develop competitive intelligence, the information necessary to decide how best to manage in the competitive environment they have identified. Porter’s competitive analysis, discussed earlier, can guide environmental scanning and help managers evaluate the competitive potential of different environments. Table 2.2 describes two extreme environments: an attractive environment, which gives a firm a competitive advantage, and an unattractive environment, which puts a firm at a competitive disadvantage.14

### Scenario Development

As managers attempt to determine the effect of environmental forces on their organizations, they frequently develop scenarios of the future. Scenarios combine alternative combinations of different factors into a total picture of the environment and the firm. For example, as Congress and the president try to work toward a balanced budget and eventually reduce the federal debt, they have developed several different scenarios about what the economy is likely to do over the next decade or so. Frequently, organizations develop a best-case scenario (i.e., if events occur that are favorable to the firm), a worst-case scenario (i.e., if events are all unfavorable), and some middle-ground alternatives. The value of scenario development is that it helps managers develop contingency plans for what they might do given different outcomes.15

### Forecasting

Whereas environmental scanning is used to identify important factors and scenario development is used to develop alternative pictures of the future, forecasting is used to predict exactly how some variable or variables will change in the future. For example, in making capital investments, firms may try to forecast how interest rates will change. In deciding to expand or downsize a business, firms may try to forecast the demand for goods and services or forecast the supply and demand of labor they probably would

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**TABLE 2.2**

<table>
<thead>
<tr>
<th>Environmental Factor</th>
<th>Unattractive</th>
<th>Attractive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitors</td>
<td>Many; low industry growth; equal size; commodity</td>
<td>Few; high industry growth; unequal size differentiated</td>
</tr>
<tr>
<td>Threat of entry</td>
<td>High threat; few entry barriers</td>
<td>Low threat; many barriers</td>
</tr>
<tr>
<td>Substitutes</td>
<td>Many</td>
<td>Few</td>
</tr>
<tr>
<td>Suppliers</td>
<td>Few; high bargaining power</td>
<td>Many; low bargaining power</td>
</tr>
<tr>
<td>Customers</td>
<td>Few; high bargaining power</td>
<td>Many; low bargaining power</td>
</tr>
</tbody>
</table>

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use. Available publications such as *Business Week’s Business Outlook* provide forecasts to businesses both large and small.

Although forecasts are designed to help executives make predictions about the future, their accuracy varies from application to application. Because they extrapolate from the past to project the future, forecasts tend to be most accurate when the future ends up looking a lot like the past. Of course, we don’t need sophisticated forecasts in those instances. Forecasts are most useful when the future will look radically different.

The National Aeronautics and Space Administration (NASA) leads the world in preparing and launching missions from earth to the frontiers of space. However, an audit for the President’s Quality Award suggested that NASA consider benchmarking as a way to progress from incremental improvement to breakthrough improvements.

To improve processes, NASA and its contractors were challenged to begin sharing information, a concept that initially was met with resistance. Because the contractors were essentially competitors and had closely guarded information and performance levels, they hesitated to work in collaborative benchmarking efforts. Over time, however, reluctance to share information was overcome as participants realized that NASA’s objective was to provide an opportunity to learn from contractors and help them improve their own processes, rather than to force every participant’s process into the same mold. Soon the consortium participants learned to work together as a team to facilitate effective benchmarking, optimize efficiencies, and leverage quality improvements across all participating organizations.

Participants were encouraged to share practices and learn more about how each organization achieved its results. As the various practices were discussed, the team began to identify the processes that contributed to performance that was superior to that of the other organizations. These were identified as best practices; team participants then adapted the best practices to their own organizations. In adapting and implementing these best practices, contractors produced a combined savings of $41,000 and reduced cycle time by 57 percent. These results benefited each participant organization as well as NASA—their common customer.

Consortium benchmarking like that used by NASA can be a cost-effective alternative to conventional benchmarking. When participants join forces, the cost to each participant is generally less than it would be for each contractor to conduct a study individually. Continued informal benchmarking among the consortium process owners has a synergistic benefit by creating a culture that values continual improvement and teamwork to achieve excellence. It builds a foundation for continued benchmarking, formal and/or informal, through the use of common terminology, tools, and techniques.

The approach prevents “industrial tourism,” or plant visits simply to see what is out there. Benchmarking can provide a wealth of ideas on which to build significant improvement. The commitment of resources to participate in a benchmarking study is typically well worth the effort involved because of the insights that result from learning from others.

from the past. Unfortunately, that is when forecasts tend not to be so accurate. The more things change, the less confidence we tend to have in our forecasts. The best advice for using forecasts might include the following:

- Use multiple forecasts and perhaps average their predictions.
- Remember that accuracy decreases the farther into the future you are trying to predict.
- Forecasts are no better than the data used to construct them.
- Use simple forecasts (rather than complicated ones) where possible.
- Important events often are surprises and represent a departure from predictions.\textsuperscript{16}

**Benchmarking**

In addition to trying to predict changes in the environment, firms can undertake intensive study of the best practices of various firms to understand their sources of competitive advantage. **Benchmarking** means identifying the best-in-class performance by a company in a given area, say, product development or customer service, and then comparing your processes to theirs. To accomplish this, a benchmarking team would collect information on its own company's operations and those of the other firm in order to determine gaps. These gaps serve as a point of entry to learn the underlying causes of performance differences. Ultimately, the team would map out a set of best practices that lead to world-class performance. We will discuss benchmarking further in Chapter 4.\textsuperscript{17}

**Responding to the Environment**

Organizations have a number of options for responding to the environment. In general, these options can be grouped into three categories: (1) adapting to the environment, (2) influencing the environment, and (3) selecting a new environment.

**Adapting to the Environment: Changing Yourself**

To cope with environmental uncertainty, organizations frequently make adjustments in their structures and work processes. In the case of uncertainty arising from environmental complexity, we can say that organizations tend to adapt by **decentralizing** decision making. For example, if a company faces a growing number of competitors in various markets, if different customers want different things, if the characteristics of different products keep increasing, and if production facilities are being built in different regions of the world, it may be impossible for the chief executive (or a small group of top executives) to keep abreast of all activities and understand all the operational details of a business. In these cases, the top management team is likely to give authority to lower-level managers to make decisions that benefit the firm. The term **empowerment** is used frequently today to talk about this type of decentralized authority. We will address empowerment and decision making in more detail in Chapters 3 and 9.

In response to uncertainty caused by change (dynamism) in the environment, organizations tend to establish more flexible structures. In today's business world, it is commonplace for the term **bureaucracy** to take on a bad connotation. Most of us recognize that bureaucratic organizations tend to be formalized and very stable; frequently they are unable to adjust to change or exceptional circumstances that "don't fit the rules." And while bureaucratic organizations may be efficient and controlled if the environment is stable, they tend to be slow-moving and plodding when products, technologies, customers, competitors, and the like start changing over time. In these cases, more **organic** structures tend to have the flexibility needed to adjust to change. Although we will discuss organic structures in more detail in Chapter 9, suffice it to say here that they are less formal than bureaucratic organizations, and so decisions tend to be made more
through interaction and mutual adjustment among individuals rather than via a set of predefined rules. Table 2.3 shows four different approaches that organizations can take in adapting to environmental uncertainty.

**Adapting at the Boundaries** From the standpoint of an open system, organizations create buffers on both the input and output sides of their boundaries with the environment. **Buffering** is one such approach used for adapting to uncertainty. On the input side, organizations establish relationships with employment agencies to hire part-time and temporary help during rush periods when labor demand is difficult to predict. The growth of contingent workers in the U.S. labor force is a good indication of the popularity of this approach to buffering input uncertainties. On the output side of the system, most organizations use some type of ending inventories that allow them to keep merchandise on hand in case a rush of customers decide to buy their products. Auto dealers are a particularly common example of this use of buffers, but we can see similar use of buffer inventories in fast-food restaurants, bookstores, clothing stores, and even real estate agencies.\(^{18}\)

<table>
<thead>
<tr>
<th>Complex</th>
<th>Stable</th>
<th>Dynamic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Decentralized</td>
<td>Decentralized</td>
</tr>
<tr>
<td>Bureaucratic (standardized skills)</td>
<td>Organic (mutual adjustment)</td>
<td></td>
</tr>
<tr>
<td>Centralized</td>
<td>Centralized</td>
<td></td>
</tr>
<tr>
<td>Bureaucratic (standardized work processes)</td>
<td>Organic (direct supervision)</td>
<td></td>
</tr>
</tbody>
</table>

**Table 2.3**
Four Approaches for Managing Uncertainty

Auto dealers typically have a buffer inventory of products but then cut prices to increase demand at the end of the model year.
In addition to buffering, organizations may try smoothing or leveling normal fluctuations at the boundaries of the environment. For example, during winter months (up north) when automobile sales drop off, it is not uncommon for dealers to cut the price of their in-stock vehicles to increase demand. At the end of each clothing season, retailers discount their merchandise to clear it out in order to make room for incoming inventories. These are each examples of smoothing environmental cycles in order to level off fluctuations in demand.

Adapting at the Core
While buffering and smoothing work to manage uncertainties at the boundaries of the organization, firms also can establish flexible processes that allow for adaptation in their technical core. For example, firms increasingly try to customize their products and services to meet the varied and changing demands of customers. Even in manufacturing, where it is difficult to change basic core processes, firms are adopting techniques of mass customization that help them create flexible factories.

Instead of mass-producing large quantities of a “one-size-fits-all” product, with mass customization organizations can produce individually customized products at an equally low cost. Whereas Henry Ford used to claim that “you could have a Model T in any color you wanted, as long as it was black,” auto companies now offer a wide array of colors and trim lines, with different options and accessories. The process of mass customization involves the use of a network of independent operating units in which each performs a specific process or task such as making a dashboard assembly on an automobile. When an order comes in, different modules join forces to deliver the product or service as specified by the customer. We will discuss mass customization and flexible factories in more depth in Chapter 9.

Influencing Your Environment
In addition to adapting or reacting to the environment, organizations can develop proactive responses aimed at changing the environment. Two general types of proactive responses are independent action and cooperative action.

Independent Action
A company uses independent strategies when it acts on its own to change some aspect of its current environment. Table 2.4 shows the definitions and uses of these strategies. For example, when Southwest Airlines enters a new market, it demonstrates competitive aggression by cutting fares so that other, less-efficient airlines must follow it down. In contrast, Kellogg Company typically promotes the cereal industry as a whole, thereby demonstrating competitive pacification. Weyerhaeuser Company advertises its reforestation efforts (public relations). First Boston forgoes its Christmas party and donates thousands of dollars to the poor (voluntary action). Dow Chemical recently sued General Electric for hiring away some of its engineers (legal action). Dow Corning lobbied and recently won the right to put silicon implants back on the market (political action).

Each of these examples shows how organizations—on their own—can have an impact on the environment.

Cooperative Action
In some situations, two or more organizations work together using cooperative strategies to influence the environment. Table 2.5 shows several examples of cooperative strategies. An example of contracting occurs when suppliers and customers, or managers and labor unions, sign formal agreements about the terms and conditions of their future relationships. These contracts are explicit attempts to make their future relationship predictable. An example of cooptation might occur when universities invite wealthy alumni to join their boards of directors.
Finally, an example of coalition formation might be when local businesses band together to curb the rise of employee health care costs and when organizations in the same industry form industry associations and special-interest groups. You may have seen cooperative advertising strategies, such as when dairy producers, beef producers, orange growers, and the like, jointly pay for television commercials.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Definition</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive aggression</td>
<td>Exploiting a distinctive competence or improving internal efficiency for competitive advantage.</td>
<td>Aggressive pricing, comparative advertising (e.g., Advil)</td>
</tr>
<tr>
<td>Competitive pacification</td>
<td>Independent action to improve relations with competitors.</td>
<td>Helping competitors find raw materials</td>
</tr>
<tr>
<td>Public relations</td>
<td>Establishing and maintaining favorable images in the minds of those making up the environment.</td>
<td>Sponsoring sporting events</td>
</tr>
<tr>
<td>Voluntary action</td>
<td>Voluntary commitment to various interest groups, causes, and social problems.</td>
<td>Ronald McDonald Houses</td>
</tr>
<tr>
<td>Legal action</td>
<td>Company engages in private legal battle with competition on antitrust deceptive and advertising or other grounds.</td>
<td>Blue Mountain Art, Inc.‘s, lawsuit against Hallmark for allegedly copying its cards</td>
</tr>
<tr>
<td>Political action</td>
<td>Efforts to influence elected representatives to create a more favorable business environment or limit competition.</td>
<td>ARCO’s corporate constituency programs; issue advertising; lobbying at state and national levels</td>
</tr>
</tbody>
</table>

TABLE 2.4 Independent Action

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Definition</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contraction</td>
<td>Negotiation of an agreement between the organization and another group to exchange goods, services, information, patents, and so on.</td>
<td>Contractual marketing systems</td>
</tr>
<tr>
<td>Cooptation</td>
<td>Absorbing new elements into the organization’s leadership structure to avert threats to its stability or existence.</td>
<td>Consumer and labor representatives and bankers on boards of directors</td>
</tr>
<tr>
<td>Coalition</td>
<td>Two or more groups coalesce and act jointly with respect to some set of issues for some period of time.</td>
<td>Industry associations; political initiatives of the Business Roundtable and the U.S. Chamber of Commerce</td>
</tr>
</tbody>
</table>

TABLE 2.5 Cooperative Action
At a more organizational level, organizations establish strategic alliances, partnerships, joint ventures, and mergers with competitors to deal with environmental uncertainties. Cooperative strategies such as these make most sense when (1) taking joint action will reduce the organizations’ costs and risks and (2) cooperation will increase their power (that is, their ability to successfully accomplish the changes they desire).

Changing the Environment You Are In

As we noted previously, organizations can cope with environmental uncertainty by changing themselves (environmental adaptation), changing the environment, or changing the environment they are in. We refer to this last category as **strategic maneuvering**. By making a conscious effort to change the boundaries of its competitive environment, firms can maneuver around potential threats and capitalize on arising opportunities.22 Table 2.6 defines and gives examples of several of these strategies, including domain selection, diversification, merger and acquisition, and divestiture.

Organizations engage in strategic maneuvering when they move into different environments. Some companies, called **prospectors**, are more likely than others to engage in strategic maneuvering.23 Aggressive companies continuously change the boundaries for their task environments by seeking new products and markets, diversifying, and merging or acquiring new enterprises. In these and other ways, corporations put their competitors on the defensive and force them to react. **Defenders**, on the other hand, stay within a more limited, stable product domain.

**TABLE 2.6**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Definition</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domain selection</td>
<td>Entering industries or markets with limited competition or regulation and ample suppliers and customers; entering high-growth markets.</td>
<td>IBM’s entry into the personal computer market; Miller’s entry into the light-beer market.</td>
</tr>
<tr>
<td>Diversification</td>
<td>Investing in different types of businesses, manufacturing different types of products, or geographic expansion to reduce dependence on a single market or technology.</td>
<td>General Electric’s purchase of RCA and NBC.</td>
</tr>
<tr>
<td>Merger and acquisition</td>
<td>Combining two or more firms into a single enterprise; gaining possession of an ongoing enterprise.</td>
<td>RJR and Nabisco, Sperry and Burroughs (now Unisys), Boeing and McDonnell Douglas.</td>
</tr>
<tr>
<td>Divestiture</td>
<td>Selling one or more businesses.</td>
<td>Kodak and Eastman Chemical.</td>
</tr>
</tbody>
</table>

Three general considerations help guide management’s response to the environment. First, organizations should attempt to change appropriate elements of the environment. Environmental responses are most useful when aimed at elements of the environment that (1) cause the company problems, (2) provide it with opportunities, and (3) allow the company to change successfully. Thus, automobile companies faced with intense competition from Japanese automakers successfully lobbied (along with labor) for government-imposed ceilings on Japanese imports. And one charcoal producer, hoping to increase consumers’ opportunities to use its product, launched a campaign to increase daylight saving time.

Second, organizations should choose responses that focus on pertinent elements of the environment. If a company wants to better manage its competitive environment, competitive aggression and pacification are viable options. Political action influences the legal environment, and contracting helps manage customers and suppliers.

Third, companies should choose responses that offer the most benefit at the lowest cost. Return-on-investment calculations should incorporate short-term financial considerations as well as long-term impact. Strategic managers who consider these factors carefully will guide their organizations to competitive advantage more effectively.
How to analyze the competitive environment.

Environments can range from favorable to unfavorable. To determine how favorable a competitive environment is, managers should consider the nature of the competitors, potential new entrants, threat of substitutes, suppliers, and customers. Analyzing how these five forces influence the organization provides an indication of potential threats and opportunities. Attractive environments tend to be those which have high industry growth, few competitors, products that can be differentiated, few potential entrants, many barriers to entry, few substitutes, many suppliers (none with much power), and many customers. After identifying and analyzing competitive forces, managers must formulate a strategy that minimizes the power external forces have over the organization (a topic discussed more fully in Chapter 5).

How organizations respond to environmental uncertainty.

Responding effectively to the environment often involves devising proactive strategies to change the environment. Strategic maneuvering, for example, involves changing the boundaries of the competitive environment through domain selection, diversification, mergers, and the like. Independent strategies, on the other hand, do not require moving into a new environment but rather changing some aspect of the current environment through competitive aggression, public relations, legal action, and so on. Finally, cooperative strategies, such as contracting, cooptation, and coalition building, involve the working together of two or more organizations.

DISCUSSION QUESTIONS

1. This chapter's opening quote by Peter Drucker said, “The essence of a business is outside itself.” What do you think this means? Do you agree?
2. What are the most important forces in the macroenvironment facing companies today?
3. Go back to the telecom example in "Setting the Stage." What other organizations have faced or are facing similar circumstances in their external environments?
4. What are the main differences between the macroenvironment and the competitive environment?
5. What kinds of changes do companies make in response to environmental uncertainty?
6. We outlined several proactive responses that organizations can make to the environment. What examples have you seen recently of an organization’s responding effectively to its environment? Did the effectiveness of the response depend on whether the organization was facing a threat or an opportunity?

Many New Airlines will Never Grow Old

Thanks to a weak economy and the continuing effects of September 11, 2001, many new entrants are struggling or going out of business. Pro Air Inc., grounded by federal regulators over safety concerns, and tiny AccessAir in Iowa have both filed for bankruptcy protection, as has Vanguard Airlines Inc., hurt by high fuel prices, operational problems, and overly rapid growth. As start-ups have discovered so often in the cutthroat airline business, it’s easy to enter the fray but hard to succeed. Yes, the giants have been accused of crushing the small fry with predatory tactics, fortress hubs, and big frequent-flier programs. But start-ups often make mistakes—from choosing the wrong routes to running sloppy operations. That worries consumer advocates, who want more competition to keep the majors in check. And if consolidation follows on the heels of UAL Corp.’s deal to buy US Airways Group Inc., “you’re going to need new entry more than ever,” says Kevin P. Mitchell, chairman of the Business Travel Coalition, which represents big corporations.

Certainly, there are success stories. JetBlue Airways, the best-financed start-up in airline history, appears to be off to a phenomenal start since February 2000. The low-fare airline that offers live TV and leather upholstery is filling 72 percent of the seats on its eight new Airbus A320s. It flies to 9 cities, going up to 12 in November 2000. CEO David Neeleman says the airline, based at New York’s John F. Kennedy International Airport, posted a “double-digit” profit margin in August and should be profitable this year. It just raised another $30 million from its investors on top of the $130 million it started with. Neeleman “is the most successful airline entrepreneur of the last 10 years,” says Darryl Jenkins, director of the Aviation Institute at George Washington University.

And after a rocky start, six-year-old Frontier Airlines Inc. in Denver seems to be on course. It is benefiting in part from operational and labor woes at UAL’s United Airlines. Second-quarter net income doubled to more than $16 million as the airline attracted more business passengers and raised fares. Likewise, 10-year-old Spirit Airlines has proved to be a survivor after shifting its strategy to avoid markets dominated by one major carrier. It even moved its home base last year from Northwest Airline Corp.’s hub in Detroit to Fort Lauderdale.

But for every JetBlue and Frontier, there seems to be a Pro Air. Even before the Federal Aviation Administration revoked Pro Air’s operating certificate in 2000—a move Pro Air is contesting—the airline was ailing. Despite winning contracts from major companies such as General Motors Corp., it failed to offer the frequent flights that business passengers demanded and spread itself too thin, with only three aircraft. What's more, it chose to compete head-on in Detroit with Northwest. “They
were lucky to fly as long as they did;” says Cameron R. Burr, a partner at the Burr Group, an investment firm. Pro Air insists it was about to raise $70 million right before the FAA shut it down.

Some experts see a smoother ride ahead. Led by United and its recent pilot contract, major carriers are expected to see big increases in labor costs. That probably means higher fares for passengers—and a bigger pricing umbrella for the little guys to work under. And even if the economy softens, “that will refocus [customers] on economic value” instead of frequent-flier benefits, says Stanley L. Pace, head of Bain & Co.’s airline practice. But until then, the new guys in the skies have little room for error.

QUESTIONS
1. Which of the five forces of competition seem to be having the greatest impact on the airline industry: buyers, suppliers, rivals, new entrants, or substitutes? How attractive is this industry?
2. Imagine you were running one of these start-up airlines. What response(s) would you suggest given the environmental situation?
3. Do you see any similarities between the airline industry and the telecom industry discussed at the beginning of the chapter in “Setting the Stage”?