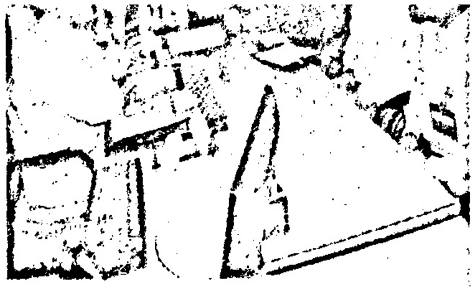
Strategy Formulation



CHAPTER THREE
Environmental Appraisal

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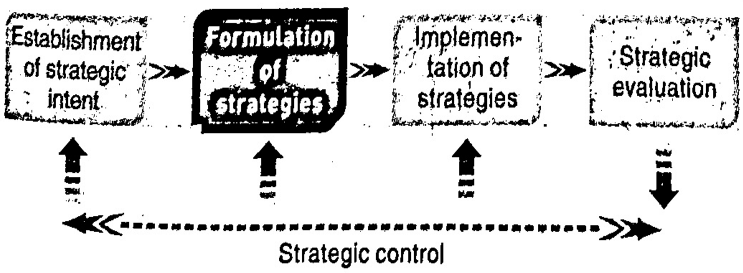

The third part of this book on strategy formulation is the most comprehensive of all containing seven chapters. The initial two chapters are on SWOT analysis with one chapter each devoted to environmental and organisational appraisals. These appraisals tell us what opportunities and threats exist in the environment and the strengths and weaknesses of the organisation. The three-chapter series that follows is on corporate strategies. We get a chance here to study the various types of corporate strategies that organisation formulate. In doing so, we study the traditional strategies of concentration, integration, diversification, stability, retrenchment, restructuring as well as newer forms of internationalisation, cooperation, and digitalisation. One chapter on business strategies explains the popular typology of generic competitive strategies. The last chapter in this part is on the process of strategic analysis and choice. The net outcome of the whole process of strategic formulation is the strategic plan that becomes the basis for strategy implementation.

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Just like everything exists in the physical environment, organisations exist in the business environment. Organisations make up groups as in the case of a group of rival companies that form an industry. We observed how the food processing industry in India is affected by the different levels of the environment at the global and national levels. The industry environment, as we will see shortly, constitutes one of the most significant parts of the environment for an organisation. Food processing companies are quite likely to be affected by how the food processing industry shapes up.

Strategic management is basically about dealing with the external environment and establishing a linkage with it. These linkages are the strategies. This chapter is devoted to an understanding of the external environment that organisations face. Environment can be divided into external and internal. This chapter deals with different aspects of the external environment. The internal environment has been left for discussion in the next chapter.

3.1 CONCEPT OF ENVIRONMENT

Environment literally means the surroundings, external objects, influences or circumstances under which someone or something exists. The environment of any organisation is 'the aggregate of all conditions, events and influences that surround and affect it.'[2] Since the environment influences an organisation in multitudinous

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ways, its understanding is of crucial importance. The concept of environment can be understood by looking at some of its characteristics. Let us read Exhibit 3.1 that presents six mega trends that are likely to shape the Indian economy, industry and markets in the near future. Industries and companies are quite interested in knowing about such trends as these affect their businesses in multifarious ways.

Exhibit 3.1 Six mega trends likely to shape India's future

T. N. Ninan, editor of *Business Standard* and former editor of *The Economic Times*, forecasts six mega trends that are likely to shape the Indian economy in the near future. He calls them 'mega' trends as they cannot be easily reversed, have large ripple effects and define the future.

The trend of acquiring of scale The Indian economy, markets and companies are no longer small or tiny. For example, the total Indian car market in 2000 was just half a million vehicles. By 2010, a single company may be turning out twice that number. A budding entrepreneur like Jignesh Shah, is valued at Rs. 5000 crore in 2007, which is roughly equal to what the Ambani family wealth was estimated in 2000.

The trend of spread of connectivity and awareness The Indian telecom market was just 5 million connections and is now being valued at over 180 million, enhancing connectivity across the nation. Similarly, TV sets increasing 12 times or trucks moving at double the speed, on new highways, affect the productivity of industries directly or indirectly.

The trend of growth of the middle class In 2001, there were an estimated 61 million Indians belonging to families earning more than Rs 2 lakh per year. In 2005, that number reached 100 million and by 2010 is likely to be 173 million. In addition to adding to the consumerism, the middle class is likely to demand better civic amenities such as reliable power, clean water and comfortable mass transport systems.

The trend of growing problems of growth Environmental degradation, rising energy demand and income disparities are the problems being increasingly faced and are likely to worsen in the near future.

The trend of increasing openness to the world There are indices such as the foreign trade component of India's GDP that is nearly 55 per cent, foreign institutional investors holdings of 25 per cent of Indian stocks, more Indian companies buying overseas companies abroad, more Indian students studying abroad and the like, indicating the increasing openness of India and Indians to the world. This comes from greater self-confidence, faster acceptance of new influences and ideas and willingness to accept global benchmarking, resulting in a more adaptive and efficient system.

The trend of continuing dominance of youth Demographically, nearly half of India is under 25 years of age. Not only are there a higher number of younger people but they are also different from the older generation in many ways. For instance, they are more mobile and volatile, offering new opportunities and challenges to marketers.

Source: Based on T. N. Ninan, "Six mega trends that define India's future", *Business Standard*, January 6, 2007; Also available at *http://www.rediff.com/money/2007/jan/06bspec.htm*, Retrieved January 15, 2007.

Characteristics of Environment

Business environment (or simple environment) exhibits many characteristics. Some of the important and obvious characteristics are briefly described here.

1. Environment is Complex The environment consists of a number of factors, events, conditions and influences arising from different sources. All these do not exist in isolation, but interact with each other to create an entirely new sets of influences. It is difficult to comprehend at once what factors constitute a given environment. All in all, environment is a complex phenomenon—relatively easier to understand in parts but difficult to grasp in its totality.

2. Environment is Dynamic The environment is constantly changing in nature. Due to the many and varied influence operating, there is dynamism in the environment causing it to continuously change its shape and character.

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3. Environment is Multi-faceted What shape and character an environment assumes depends on the perception of the observer. A particular change in the environment, or a new development, may be viewed differently by different observers. This is frequently seen when the same development is welcomed as an opportunity by one company while another company perceives it as a threat.

4. Environment has a Far-reaching Impact The environment has a far-reaching impact on organisations. The growth and profitability of an organisation depends critically on the environment in which it exists. Any environmental change has an impact on the organisation in several different ways.

Since the environment is complex, dynamic, multi-faceted and has a far-reaching impact, dividing it into external and internal components enables us to understand it better. But before we do that, it is important to understand that strategic management is increasingly becoming conscious of the nature of the environment and the ways in which it affects organisations.

The traditional approach to strategic management has led to an emphasis on control, order and predictability. But these are antithetical to the concept of organisations and environment as we realise now. The organisation and the environment are, in reality, more unpredictable, uncertain and non-linear. Exhibit 3.2 presents an overview of the chaos theory and its application to strategic management.

Exhibit 3.2 Complexity and chaos in strategic management

The complexity theory, of which chaos theory is a part, deals with the process of self-organisation. Chaos theory, proposed by Edward Lorenz and Mitchel Feigenbaum, postulates that at the root of all complex systems—whether they are organisations or the environment—there are a set of rules that provide a dynamic order to the surface complexity. These systems cannot be considered as linear systems where a simple cause and effect model can explain the behaviour of these systems. Rather, these systems are non-linear and dynamic in nature. Any change that takes place in the non-linear systems is chaotic. Chaos theory uses the mathematical models, known as chaotic models, to interpret the process of non-linear and dynamic systems. The phenomenon of chaos is observed in a wide variety of processes—biological, sociological, economic and meteorological. The applications of chaos theory in management may range from predicting market behaviour and financial forecasting, to anticipating competitive strategies.

Organisations and environments display many of the characteristics of the living eco-systems—as these are also dynamic, ever changing systems—making it possible to apply the tenets of chaos theory to them.

In suggesting the use of chaos theory to strategic management, D. Levy gives the following reasons:

- Long-term planning is difficult
- Industries do not reach a stable equilibrium
- Dramatic changes can occur unexpectedly
- Short-term forecasts and predictions of patterns can be made
- Guidelines are needed to cope with complexity and uncertainty

The lesson that students of strategic management need to learn is that, in a dynamic environment, it is suicidal for organisations to remain static. They have to forego maintaining an internal orientation and attempt to change dynamically as the environment changes. Managers should not fall into the trap of over-rationalisation, over-reliance on sophisticated modelling and the futile attempt to create order where a state of equilibrium simply cannot exist for long. Creative disorder in the environment, as it is the universe, needs to be taken to heart by managers.

Sources: D. Levy, "Chaos theory and strategy: Theory, application and managerial implications", *Strategic Management Journal*, Vol. 13, 1992, pp. 111- 125; D. N. Chorafas, *Chaos Theory in the Financial Markets*, Irwin, Chicago, 1994; R D Stacey, *Complexity and Creativity in Organisations*, San Francisco, Berrett-Koehler, 1996; R. T. Pascale, M. Millemann & L. Gioja, *Surfing the Edge of Chaos: The Laws of Nature and the New Laws of Business*, Crown Business, 2000.

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Let us get ahead and grapple with the complexity of the environment by its division into internal and external environments.

Internal and External Environment — 1

The internal environment refers to all factors within an organisation that impact strengths or cause weaknesses of a strategic nature. The external environment includes all the factors outside the organisation which provide opportunities or pose threats to the organisation.

The environment in which an organisation exists can, therefore, be described in terms of the strengths and weakness existing in the internal environment and the opportunities and threats operating in the external environment. The four environmental influences could be described as below.

Internal environment:

1. *Strength* is an inherent capacity which an organisation can use to gain strategic advantage. Examples of strength are: good reputation among customers, resources, assets, people, experience, knowledge, data and capabilities.
2. *Weakness* is an inherent limitation or constraint which creates strategic disadvantages. Examples of weakness are: gaps in capabilities, financial deadlines, low morale and overdependence on a single product line.

External environment:

3. *Opportunity* is a favourable condition in the organisation's environment which enables it to consolidate and strengthen its position. Examples of opportunity are: economic boom, favourable demographic shifts, arrival of new technologies, loosening of regulations, favourable global influences and unfulfilled customer needs.
4. *Threat* is an unfavourable condition in the organisation's environment which creates a risk for, or causes damage to, the organisation. Examples of threat are: economic downturn, demographic shifts, new competitors, unexpected shifts in consumer tastes, demanding new regulations, unfavourable political or legislation, new technology and loss of key staff.

An understanding of the external environment, in terms of the opportunities and threats and the internal environment, in terms of the strengths and weakness, is crucial for the existence, growth and profitability of any organisation. A systematic approach to understanding the environment is the SWOT analysis.

SWOT Analysis - learn.

SWOT analysis, evolved during the 1960s at Stanford Research Institute, is a very popular strategic planning technique having applications in many areas including management. Organisations perform a SWOT analysis to understand their internal and external environments. SWOT, which is the acronym for strengths, weaknesses, opportunities and threats, is also known as WOTS-UP or TOWS analysis. Through such an analysis, the strengths and weaknesses existing within an organisation can be matched with the opportunities and threats operating in the environment so that an effective strategy can be formulated. An effective organisational strategy, therefore, is one that capitalises on the opportunities through the use of strengths and neutralises the threats by minimising the impact of weaknesses, to achieve pre-determined objectives.

A simple application of the SWOT analysis technique involves these steps:

1. Setting the objectives of the organisation or its unit
2. Identifying its strengths, weaknesses, opportunities and threats
3. Asking four questions
   (a) How do we maximise our strengths?
   (b) How do we minimise our weaknesses?

S - Inherent capacity
W - Inherent limitation
internal & comes from functional area
O - fav. condition in org env.
T - unfav. cond. which creates risk

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(c) How do we capitalise on the opportunities in our external environment?
(d) How do we protect ourselves from threats in our external environment?

4. Recommending strategies that will optimise the answers from the four questions

The SWOT analysis is usually done with the help of a template in the form of a four-cell matrix, each cell of the matrix representing the strengths, weaknesses, opportunities and threats. The analysis for preparing the SWOT matrix could be done by a group of managers in a workshop session. The session could use the brainstorming technique for generating ideas about the SWOT factors. A typical SWOT analysis matrix for a hypothetical organisation is shown in Exhibit 3.3.

Exhibit 3.3 A typical SWOT matrix

STRENGTHS	WEAKNESSES
- Favourable location - Excellent distribution network - ISO 9000 quality certification - Established R & D Centre - Good management reputation	- Uncertain cash flow cf - Weak management information system MIS - Absence of strong USP for major product lines - Low worker commitment
OPPORTUNITIES	**THREATS**
- Favourable industry trends - Low technology options available - Possibility of niche target market - Availability of reliable business partners	- Unfavourable political environment - Obstacles in licensing new business - Uncertain competitors' intentions - Lack of sustainable financial backing

SWOT analysis has several benefits, among the major being:

- Simple to use
- Low cost
- Flexible and can be adapted to varying situations
- Leads to clarification of issues
- Development of goal-oriented alternatives
- Useful as a starting point for strategic analysis

The following could be the pitfalls of using the SWOT analysis indiscriminately:

- Simplicity of use may turn to be simplistic by trivialising the reality that may be more complex than represented in SWOT matrices.
- May result in just compiling lists rather than think about what is really important for achieving objectives.
- Usually reflects an evaluator's position and viewpoint that can be misinterpreted to justify a previously decided course of action, rather than be used as a means to open new possibilities.
- Chances exist where strengths may be confused with opportunities or weaknesses with threats.
- May encourage organisations to take a lazy course of action of looking for strengths that match opportunities rather than developing new strengths that could match the emerging opportunities.

The process of strategy formulation starts with and critically depends on, the appraisal of the internal and external environment of an organisation. In this chapter, we will attempt to understand the external environment and, in the next chapter, we will take up the internal environment for discussion.

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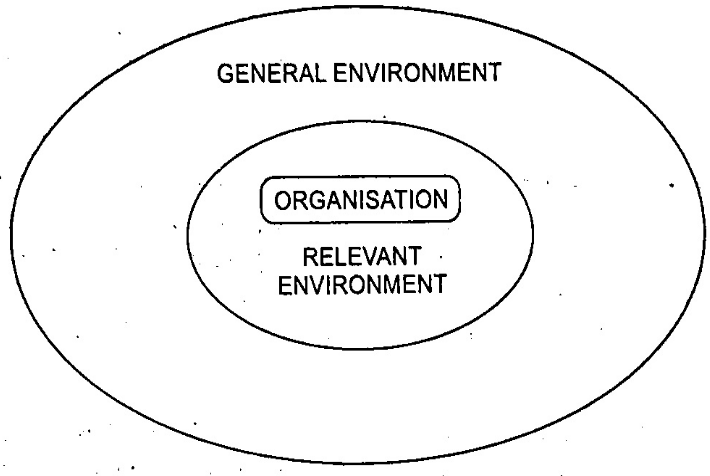
General *versus* Relevant Environment

The external environment, as we said earlier, consists of all the factors which provide opportunities or pose threats to an organisation. In a wider sense, the external environment encompasses a variety of sectors like international, national and local economy, social changes, demographic variables, political systems, technology, attitude towards business, energy sources, raw materials and others resources and many other macro-level factors. We could designate such a wider perception of the environment as the general environment. All organisations, in some way or the other, are concerned about the general environment. But the immediate concerns of any organisation are confined to just a part of the general environment which is of high strategic relevance to the organisation. This part of the environment could be termed as the immediately relevant environment or simply, the relevant environment. The conception of the business environment of an organisation is presented in Exhibit 3.4.

Exhibit 3.4 The business environment of an organisation



A conscious identification of the relevant environment enables the organisations to focus its attention on those factors which are intimately related to its mission, purpose, objectives and strategies. Depending on its perception of the relevant environment, an organisation takes into account those influences in its surrounding which have an immediate impact on its strategic management process. Having identified its relevant environment, an organisation can systematically appraise it and incorporate the results of such an appraisal in strategic planning. In order to cope with the complexity of the environment, it is feasible to divide it into different sectors.

Classification of Environmental Sectors

Aguilar evolved a categorisation scheme for grouping different kinds of information related to the environment into sectors such as customers, competitors, suppliers, technology; social, political, economic conditions, etc.[3] Keegan suggests that the sector categorisation should be such that these sectors must be exhaustive, i.e., each item of information should find a place in one of the sectors; the sectors must be mutually exclusive so that any given item of information must belong to one of the category; and the classification must be functional and relate to actual scanning practices.[4]

There are several sectors into which the external/general environment could be divided into. But, in a given context, there are certain sectors that merit greater attention than the others. Exhibit 3.5 presents results of three research studies in the Indian context that attempt to identify the environmental factors on the basis of a relative ranking of the different environmental sectors.

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Exhibit 3.5 Which sectors of the environment did Indian companies focus upon?

Given below are the relative rankings of eight environmental sectors that Indian companies focus upon. The rankings are based on three research studies reported over nearly a decade (1987 - 1996).

Environmental sectors	*Dixit (1987) (N = 24)*	*Subramaniam (1989) (N = 16)*	*Shah (1996) (N = 61)*	*Overall ranking**
Market	1	1	1	1
Supplier	2	n.c.	2	2
Technological	n.c.	2	3	3
Economic	4	3	4	4
Regulatory	3	4	5	5
Political	6	5	6	6
Socio-cultural	6	6	7	7
International	5	n.c.	8	8

* Overall ranking done by the author
n.c. : 'not considered' in research study

Sources: M.R. Dixit, "Environmental Factors Relevant for Strategy Formulation" in *Indian Management*, Jan 1987, pp. 31 - 37; also as part of a larger study in M.R. Dixit, "The Concept and Practice of Scanning and Appraisal of the External Environment", *Vikalpa*, Vol. 10, No 2, Apr - June 1985, pp. 119 - 139; S. Subramaniam, "Corporate Planning Practices in India", *Economic and Political Weekly*, May 27, 1989, pp. M87 - M91; A. M. Shah, "Environmental Factors for Strategy Formulation" *Productivity*, Vol. 36, No 4, Jan - Mar 1996, pp. 594 - 599.

The research studies by Dixit (1987), Subramaniam (1989) and Shah (1996) had an identical objective of finding out the environmental sectors in the Indian context, that have a high relevance for strategy formulation by Indian organisations.[5] Certain adjustments have been made in the presentation of the results in Exhibit 3.5. Dixit's study ranks 18 domestic and 6 multinational companies separately. Here the weightage average of the relevance scores (a measure used in such studies to determine the extent to which a sector is considered relevant to strategic planning by the companies) is taken for ease of comparison. Subramaniam's study ranks sectors on their degree of relevance. Here again, the weightage average is calculated. Further, the terminology used for sectors by different researchers could be a bit different. We have relied on a common terminology in order to arrive at the overall ranking.

Of interest to us here is the fact that there was a high level of unanimity among the three researchers regarding the type of sectors that Indian companies tended to focus upon for the purpose of environmental scanning. Market environment turned out to be the most crucial factor, followed by the supplier and technological sectors. International environment did not seem to be of much significance then but in all probability, has gained primacy as larger numbers of Indian companies are integrating themselves with the global economy.

These studies identified eight environmental factors that Indian companies focussed on. These studies are of the period 1987–1997 and may seem outdated but interest in identification of environmental factors seemed to have waned not only in India, but internationally too. At present, research in environmental factors has moved to finer points such as environmental scanning behaviour of managers or its relationship with the dynamism of the environment.[6]

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