Business and strategy

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In this section we consider a number of areas of business activity and consider how an analysis of economic issues fits in with the study of business. To begin with we outline the basic business process of taking resources and transforming them into outputs that hopefully are wanted by the customer. We then:

- *consider the various forms of business that exist and the difference between a mission, an objective, and a strategy.*
- *analyse the activities that occur within a business, namely marketing, operations, finance, and human resource management.*
- *consider the factors in the external environment of business such as competition, the economy, and social trends.*

Once we have analysed the internal and external environments we consider how a firm's strategy is derived from matching its internal strengths and weaknesses to outside opportunities and threats. This is known as SWOT analysis.

Our book Foundations of Economics *obviously focuses on the economic environment of business considering both micro and macro economic factors. This particular unit shows how economic factors fit in with the overall environment in which firms operate and how changes in the external environment might influence the strategy a firm adopts.*

Business as a transformation process

All organizations are involved in some form of transformation process. They take inputs such as land, labour, capital, and entrepreneurship and turn them into outputs such as physical goods and intangible services. In many cases the output of a business is a

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combination of goods and services; for example in a restaurant you are buying a meal but also the environment and the service. The aim of all organizations is to add value, i.e. to create outputs that are worth more than the inputs. In many cases the value of inputs is measured in financial terms in which case we say that organizations aim to make a profit. A profit occurs when the revenue generated by sales exceeds the costs of providing the product. In the case of non-profit organizations such as schools and hospitals, other indicators are used to measure the value added. League tables of schools' performances, for example, might measure exam results and compare the grades achieved by students with their levels of achievement when they joined the school to measure the progress.

The nature of the transformation process obviously differs enormously from business to business. For example, it may involve manufacturing or providing services, it may be capital or labour intensive or be based on a single site or multi site. However whatever the nature of the business managers are constantly looking for new ways of adding value, either by providing benefits and products that customers are willing to pay more for or by combining resources more efficiently to reduce costs.

To increase efficiency managers are always seeking ways of producing more with the same level of inputs or producing the same amount with fewer inputs. This can be achieved in a variety of ways: changing working practices, investing in new technology, motivating and inspiring staff more effectively, and changing the way items are produced. For example, an important development in manufacturing in the last twenty years is known as lean production. This seeks to reduce wastage at all stages of the production process. It includes Just in Time production in which items are produced to order rather than in advance. This reduces stock levels because materials are only ordered and used when needed - they do not wait around in stock. Similarly, finished goods are made to order and despatched immediately rather than being produced and then waiting for someone to buy them. Just In Time production therefore removes the costs involved in storing and protecting stock. Lean production also includes a technique known as kaizen which aims to use the knowledge of employees to find ways of continuously improving the way things are done. Small, incremental changes are used to reduce costs on an ongoing basis.

Adding value can also occur by generating outputs that customers are willing to pay more for. In marketing the role of the brand has become even more important in recent years as firms attempt to get customers to identify with particular values, a lifestyle and a set of aspirations. Through effective branding items can be sold for more. Just think of a basic, plain T shirt and the effect on the price that can be charged if you add a particular brand name or logo to it. Think Prada, think Armani, think Gucci and you can see the value of a brand. Also the design features of a product can generate benefits that customers will pay more for (think of Dyson vacuum cleaners, Duralit toasters, and Jimmy Choo shoes) as well as factors such as the speed of delivery (1 hour opticians and photo processing), convenience (think home delivery), and flexibility (think top restaurant compared to a fast food chain).

Organizations are continually reviewing what they provide and how they provide it to try and add more value. Given ongoing changes in the competitive environment with new competitors, new demands, and new technologies, adding value is a dynamic process. Your parents probably bought a CD and played it at home on a CD player. You download

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and listen on an iPod. The world of music provision and retailing has changed radically forcing organizations such as EMI to rethink their business model. Your parents probably went to a travel agent to book their holiday with a package holiday company. You go online and tailor-make your own holiday. They probably went on holiday mainly within their own country or to relatively few locations overseas. You travel the world.

Organizations operate in a restless world and managers need to be looking constantly at the business environment to identify changes that could be of value to them or could possibly harm them. Interestingly, any change will have different effects on different organizations. The banning of smoking in public places may damage sales of tobacco but boost sales on patches or electronic cigarettes to help you give up smoking, for example. Later on we will examine the external environment of business in more detail but first we examine the different forms of business that exist and the internal activities that occur within an organization.

Forms of business

There are several different forms of business enterprise. The simplest is that of a sole trader. A sole trader is someone who starts up their own business. Sole traders own their businesses and make all the decisions (although they might employ people to help get some of the work done). Many entrepreneurs and small businesses (such as window cleaners, plumbers and web designers) start off as sole traders.

The advantages of being a sole trader include:

- Decision-making is quick, enabling the business to be flexible and respond to changes without lots of committees to discuss things with and without lots of forms to fill in.
- The sole trader is likely to have a sense of achievement because it is his or her own business - something they have created.
- The affairs of the business are private; the firm's accounts do not have to be registered anywhere public and profits do not have to be declared to outsiders.

The disadvantages of being a sole trader include:

- It can be very demanding running your own business; the individual involved has to take all the decisions in many different areas and this can be stressful. The person concerned may be strong in one particular field such as marketing but will have to learn how to cope with making decisions in other areas such as finance as well.
- There is no distinction in law between the person who sets up the business and the business itself. This means there is unlimited liability. If there are financial problems with the business the sole trader is personally liable for all money owed. Everything the sole trader owns is potentially at stake if there are difficulties.
- The business ends when the sole trader dies or decides to stop.

An alternative form of business is that of a company. A company has a separate legal existence in law from its owners. The company can own assets in its own right; it can sue and be sued. To create a company in the UK the owners must register the business at

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Companies House and complete documents including the Articles of Association and the Memorandum of Association. These documents provide information about the business such as details of its owners, the company name, where the head office is based, the purpose of the business, and the rules on electing company officials.

The benefits of creating a company include:

- The company has limited liability. The company is liable for all its own debts and therefore investors can only lose the funds they have invested. There is, therefore, a limit to how much they can lose. This is a vital advantage of setting up a company because it means you are more likely to attract investors because they know exactly what the downside is if it goes wrong. If there was unlimited liability you would be wary of investing in any company unless you had very tight control over the business. This is because everything you owned could be at risk. With limited liability you can invest a certain sum and let this be managed by others; obviously you will want to know what they are doing with your money but at least you know the maximum you can lose if it goes wrong and therefore you don't need to have information on absolutely every decision that is being made. With limited liability those with funds can invest them for managers to use without having to be party to every single decision. Those with funds can invest for managers to use to generate profits and returns.
- The business outlives the founders. If the original owners die or want to end their relationship with the business they can sell their shares to others and the company continues. Many companies such as WHSmith, Marks and Spencer, Cadbury have little or nothing to do with the families that originally set them up. (There are exceptions- the Mars family and the Ford family, for example, are still big shareholders of their businesses). When the founders of a company die or sell up the ownership of the company simply moves to others.

One significant difference of a company compared to a sole trader is that the accounts of a company have to be checked each year by an outside accountant (called an auditor) and then sent to Companies House. This means they are available to others to investigate and "outsiders" can see what has been earned in a given year.

In the UK there are in fact two types of company: private limited companies (these are called ltds and are in the majority by far) and public limited companies (plcs). Public limited companies can advertise their shares to the general public and so have access to far more investors. They will usually be listed on the Stock Exchange and tend to be the high profile companies such as BT, BP, Tesco, Sainsbury's, and Marks and Spencer. By being able to advertise shares to the general public plcs may be able to raise millions of pounds of finance. However, because more shareholders are involved plcs are more regulated than private companies. Their accounts have to be more detailed, for example, and there are more regulations concerning what information must be made available. Also, whereas in a private company you can restrict who shares are sold to (e.g. to keep the business under the control of family members), in a public limited company there are no restrictions on the sales of shares. This means that some of the existing owners of a company can decide to sell their shares and the others cannot stop them; this can lead to a company being takeover if the majority of shareholders sell even if it is against the wishes of some of the other owners.

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Plcs tend to have many millions of shares and because they are traded on the Stock Market they are being bought and sold every day in huge quantities. At any moment the price of the shares can be seen and so the overall value of the business is known. This can show whether a takeover is likely to desirable or not. You will regularly hear on the news of takeover bids being made for public limited companies; a bidder has decided the share price does not reflect the full potential value of the business and therefore it is worth trying to gain control of the business by gaining a majority of the shares. With a private company the sale of shares is far less frequent and there is no daily market for them; therefore the price is not immediately visible - if you want to buy you will need to negotiate with the owner of the share. A "sudden" takeover is therefore less likely.

There are, of course, other forms of business. For example, partnerships occur when individuals join together to start a business. This means they can share their skills and funds and benefit from each others' knowledge. However, it does mean each partner is very reliant on the others and has to trust them not to make mistakes because they will be liable for each other's actions.

Not-for-profit organizations also exist. These include some schools, environmental groups, and sports clubs. Many of these are charities, which means they are regulated by the Charity Commission and have a special tax status but must invest their funds in agreed causes and not make a profit.

When choosing a business form the individuals concerned must consider factors such as:
- Their willingness to share control
- Their willingness to publish information about the business
- The importance of limited liability
- The scale of investment needed to set up and run the business

The decision on the right form of business may change over time. For example, if the owners of a private company want to expand the business and bring in many more investors they may turn it into a plc and "float" it on the Stock Exchange. In some cases the main owners decide they want complete control and they buy up all the shares and make the company private again. This is what happened when Malcolm Glazer bought Manchester United in 2005 and turned it from a public company to a private company.

Why buy shares?

A shareholder is an owner of a business. If you buy an ordinary share you get one vote for each share you hold. If you have 20% of the shares you have 20% ownership of the company and 20% of the votes. However, there are other types of shares that have more or less privileges e.g. some shares do not having voting rights.
By being an owner it means you can influence what the company does (assuming you do have voting rights) and can benefit from its success. One form of reward is dividends. When the company makes a profit the shareholders vote on how much is to be retained

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(i.e. kept back for investment) and how much is to be paid out to the owners in the form of dividends.
The other way in which owners can benefit is if the value of the company increases. As a company grows your shares (e.g. your 20% of the company) become worth more and so your wealth has increased. However, as the adverts and your financial advisers always tell you, the price of shares can go down as well as up so buying a share involves risk. That's why investors will look for higher potential returns than they would putting their money in the bank because there is more risk involved.

Many shares in the UK are owned by financial institutions, such as banks and insurance companies. They have their own investors and are buying shares because of the return they provide. This means there is a great deal of pressure on managers to deliver good results. If they do not they may be fired. This can lead to “short termism” which occurs when managers focus on generating short terms profits to reward their investors and avoid projects that might take longer to earn high rewards. This may lead to a lack of investment in research and development, for example, because it make take too long.

Mission statements

The mission of an organization is the reason why it exists; what it sees as its essential purpose.

This is often written down in the form of a mission statement. A mission statement expresses the underlying aim of the business and often incorporates something regarding:

- the scope of its activities e.g. to be a UK, European or global business
- its competitive strategy e.g. to be a luxury provider or low cost operator
- its values e.g. to serve its investors or to help the community

Johnson and Johnson
Johnson and Johnson is a large provider of healthcare products and services. The company's founder wrote a statement of its values called "our Credo" in 1943 and this still dominates the company's culture. Although it does not call it a mission statement it performs a similar function:

Our Credo
We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services.
In meeting their needs everything we do must be of high quality.
We must constantly strive to reduce our costs in order to maintain reasonable prices.
Customers' orders must be serviced promptly and accurately.
Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world.
Everyone must be considered as an individual.

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We must respect their dignity and recognize their merit.
They must have a sense of security in their jobs.
Compensation must be fair and adequate, and working conditions clean, orderly and safe.
We must be mindful of ways to help our employees fulfil their family responsibilities.
Employees must feel free to make suggestions and complaints.
There must be equal opportunity for employment, development and advancement for those qualified.
We must provide competent management, and their actions must be just and ethical.

We are responsible to the communities in which we live and work and to the world community as well.
We must be good citizens – support good works and charities and bear our fair share of taxes.
We must encourage civic improvements and better health and education.
We must maintain in good order the property we are privileged to use, protecting the environment and natural resources.

Our final responsibility is to our stockholders.
Business must make a sound profit.
We must experiment with new ideas.
Research must be carried on, innovative programs developed and mistakes paid for.
New equipment must be purchased, new facilities provided and new products launched.
Reserves must be created to provide for adverse times.
When we operate according to these principles, the stockholders should realize a fair return.

www.jnj.com/

Q. How do you think "Our Credo" influences the way employees at Johnson and Johnson behave? How do you think this determines the success of the business?

Just as every individual has his or her own personality, values, and ambitions so does every business. As a result, the mission of each organization is unique. To get an idea of the variety of the missions of different companies you might want to look online at some of the websites of large companies as many of these, such as Johnson and Johnson, include their mission statements. For example, why not start with:

- AOL www.corp.aol.com/whoweare/mission.shtml
- Ford www.ford.co.uk/ie/corporateinfo
- Google www.google.com/corporate/tenthings.html
- Greenpeace www.greenpeace.org/international/about/our-mission

Objectives

Whilst a mission statement may show the general purpose of the business and indeed may inspire those who read it, it does not itself necessarily provide much practical use to

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managers. A firm's mission really needs to be turned into something more focused and less general i.e. the managers need to set out the firm's objectives. Objectives are specific targets. They set out precisely what a firm wants to achieve by a given time. For example, "to be the best sports goods business in the world" might be the mission statement of a firm whereas to "increase market share by 20% in 5 years" is an objective.

To be effective an objective should be SMART; this means it should be:

- **S**pecific: i.e. managers must clearly define what the focus is
- **M**easurable so that a target can be set and reviewed
- **A**greed so that those who set it and those who have to achieve it agree to it. There is little point forcing a target on someone - if they do not accept it they will be unlikely to work very hard to make it happen
- **R**ealistic so it is achievable rather than being a target that everyone knows cannot be hit. Unrealistic targets tend to be demoralizing and can do more harm than good
- **T**ime-specific meaning that there is a clear time horizon by which the target should be achieved

Typical business objectives focus on profits, growth, market share, and cash flow. Increasingly firms are also including objectives that relate to social responsibility, focusing on areas such as their contribution to the community, the support given to suppliers and targets to reduce any negative impact on the environment. In recent years there has been a growth in the interest of firms and their customers, employees and partners in Corporate Social Responsibility (CSR). CSR focuses on the role of a business as a citizen within society and considers the impact of an organization on society as a whole. Companies that behave socially responsibly accept obligations to society over and above their legal requirements; they do not do the bare minimum because they see the value of doing more than this and working with others. For example, social responsibility might include:

- Aiming to ensure a good quality of working life for employees
- Enabling employees to have a positive work/life balance
- Minimizing the adverse impact of your activities on the environment
- Investing in the local community
- Helping disadvantaged groups
- Treating suppliers with respect

To read about the UK government's view of the benefits of Corporate Social Responsibility visit: www.csr.gov.uk

Strategy

To achieve an objective, managers must develop a suitable strategy. A strategy is a long term plan setting out how an objective will be reached. For example, if the objective is to reduce costs, the strategy could involve relocating or reducing the labour force. If the objective is to boost revenue, the strategy may be to launch new products or to invest in a big promotional campaign.

A strategy will usually:

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- Involve relatively large sums of money
- Be relatively difficult to reverse. Once you have started to pursue a particular strategy it may not be easy switch resources in another direction
- Be relatively high risk. If you get the strategy wrong this could be costly in many ways for the business
- Set out the markets the firm wants to compete in, the products it wants to offer, and how it wants to compete (e.g. by focusing on low cost or by differentiating its offering)

One method of analysing strategies is known as the Ansoff Matrix:

	Existing products	**New products**
Existing markets	Market penetration	New product development
New markets	Market development	Diversification

- Market penetration occurs when firms focus on their existing customers and sell their existing products. For example, activities may concentrate on marketing activities to try and boost market share.
- Market development occurs when firms target their products at new segments of the market. This could be different geographical markets or different age groups or types of customer. This involves gaining an understanding of how the requirements of the customers in these segments differ.
- New product development involves an investment in innovation and research and development. This can be risky in that much investment into new products does not lead to anything and many new products launched on to the market fail to survive. However this sort of strategy is important in industries where there is constant product development such as consumer electronics.
- Diversification occurs when firms move into completely new areas with new products. Over the years, for example, Nokia has transformed itself from a paper company to a communications business. 3M has moved from mining to adhesives. Diversification can be very risky from a management perspective because it is dealing with unfamiliar resources, challenges and decisions. However it may be important to keep the business successful as conditions change. Timpsons is an interesting business in the UK that has moved into new sectors (from shoe repair to key cutting, engraving to watch repair) as a way of maintaining sales.

Organizations are often made up of several different business units (e.g. they operate in different markets and in different regions) and the strategies adopted by each of these may well differ.

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The functions of business

Although organizations differ considerably in their activities, their strategies, and the way in which they seek to add value we can identify some functions which they usually have in common.

For example:

- *Operations*: this involves the actual production and delivery of the product or service. In the primary sector this may mean growing the product (e.g. farming) or extracting it (e.g. oil); in the secondary sector this involves activities such as assembly, manufacture and construction, and in the tertiary sector this involves providing a service such as tourism, education, and insurance. Operational decisions include deciding where to produce, how to produce (e.g. what combination of resources to use and how much to produce yourself compared to how much to buy in), what volume and range of products to produce and what quality and cost targets to achieve. It also involves research and development into new products and processes.

- *Marketing:* the marketing activities of business begin with identifying customer needs. This may be through primary market research (which involves collecting new data, e.g. through surveys) or secondary market research (which uses data that already exists such as government statistics or industry surveys). Having identified customers' requirements, marketing activities aim to satisfy these needs through ensuring the firm provides the right products, at the right place and price and at the right time. Firstly, a marketing strategy must be decided: for example, managers must decide on what markets to compete in and what range of products to offer. Secondly, the strategy is implemented via the marketing mix. The marketing mix involves the 4Ps: deciding on the price, the product itself, the promotion (what is communicated about the product and how it is communicated) and the place (i.e. how it is distributed from the firm to the customer).

- *Finance:* organizations need to raise finance to get started and to invest into new projects. For example, a company may raise finance by selling shares to investors or by taking out a loan. The former involves a loss of control as the number of owners is increased. The latter will incur interest charges as the loan will have to be repaid. Firms also need to set financial targets and allocate money within the business; this is known as budgeting. Budgets will be set for a given period in the future and then compared with the actual outcomes to examine why differences occurred; this is known as variance analysis. Organizations will also produce financial reports to their investors such as balance sheets (which show what a firm owns and owes on a given day) and the profit and loss account (which shows the income and profit of a company over the last year).

- *Human resource management (HRM):* all organizations rely on their employees and HRM refers to the way in which people are managed. HRM involves activities such as the recruitment and selection of staff, the training of people, and the development and implementation of appropriate reward systems. The nature of

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these activities can have a big impact on the way people perform. A payment system based on commission, for example, will inevitably make employees focus on sales; a profit-sharing scheme might make them focus on costs as well. The way that people are managed will influence whether they turn up for work, how productive they are, and their openness to change.

These functions may be undertaken by specialist departments or in the case of smaller businesses it may be that many roles are combined. A sole trader has to undertake all these different activities for him or herself, for example.

The activities of the different functions will be derived from the overall plan of the business as a whole. This is known as the corporate strategy. The corporate strategy might be to enter international markets, for example. This would require marketing to gain an understanding of the demands and requirements of the overseas markets. Operations would need to consider the implications in terms of what is produced and where it is produced. HRM might have to recruit staff internationally and finance might have to gain a greater understanding of exchange rate issues. Within any business the various functions need to be integrated and in an effective business they will complement each other fully. For example, a desired boost in sales generated by marketing may need to be supported by additional finance to launch a promotional campaign, an increase in capacity to increase production and the recruitment of additional staff.

An organization is therefore a complex mechanism made up of interrelating parts. What the organization is designed to do is its objective; how it intends to do this is the strategy and the actual activities are carried out by the various functions. The relative importance of the functions and areas within them will vary from organization to organization. In pharmaceuticals, research and development is extremely important. In banking the effective use of information technology is particularly crucial. In the National Health Service there are hundreds of thousands of employees and so HRM is a much more complex and significant aspect of the organization compared to a sole trader.

Business and the environment

The business transformation process does not take place in a vacuum. Firms operate in a particular context and they are influenced by, and are able to influence, this environment.

The business environment can be divided into:

- *The micro-environment:* this involves individuals or organizations that a firm deals with on a regular basis. For example, suppliers, distributors, competitors, customers, and employees are all members of the micro-environment. These groups are stakeholders of the business. They all have a direct interest in the activities of the firm and are clearly affected by its actions. Managers regularly interact with others in the micro-environment and their decisions have a direct effect on them, e.g. a decision to expand may mean an increase in supplies, an increase in overtime, more deliveries, and greater profits. At the same time these stakeholder groups can have a direct impact on the firm. Labour shortages in the

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local labour market may make it more expensive to recruit, competitors launching new products may take away market share, and changes in customer tastes may require a rethinking of the marketing strategy. Delays by suppliers may lead to cash-flow problems and problems with distributors may hit sales. The micro environment therefore plays a critical role in the success and behaviour of a business.

- *The macro-environment*. This involves factors outside of the direct control of the business. These macro-factors such as the economy, government policy, and social change can have a significant effect on a firm's success but the relationship is fairly one way. A change in the exchange rate can affect the ability of a firm to sell abroad; for example, the pound rose in value to nearly 2 dollars in 2007 making UK exports expensive in America. The increasing interest in healthy eating has boosted organic sales. The ageing population has increased demand for healthcare resources. However, whilst these macro factors can fundamentally change the environment of an organization one individual business can rarely do much on its own to shape them. One firm is unlikely to be able to influence government taxation policy or new legislation, for example. The macro-environment can be analysed using PESTEL analysis which is outlined later.

Analysing the micro-environment

The micro-environment consists of stakeholder groups that a firm has regular dealings with. The way these relationships develop can affect the costs, quality, and overall success of a business. Issues in the micro-environment include:

- *Suppliers*: can they provide high quality products at a good price? Can they do this reliably in the volumes required? Have they got the flexibility to respond to a firm's demands? What is the bargaining power of these suppliers? How dependent is the firm on them? Does their approach to their staff and resources fit with your ethics? Firms must decide on issues such as who to use to supply them, on the responsibility it takes for these suppliers and on the terms and conditions it adopts. Some firms take quite an aggressive attitude towards their suppliers by trying to push down the prices and delay payments. Others view the relationship more as a partnership in which they are working together with suppliers and that by helping each other both can benefit. The importance of suppliers can be seen if things go wrong. In 2000 Ford's image was damaged when tyres on its Explorer vehicles started exploding. These tyres were produced by Bridgestone and the supplier ended up re-calling over 6.5 million tyres. In 2007 Sony batteries in several Dell laptops caught fire which caused a terrible public relations issue for the computer manufacturer and led to over 4 million laptop batteries being recalled.

- *Distributors:* often getting products to the end customers can be a major issue for firms. Imagine you sell shampoo - what you need to sell this is to get it on the shelves in the leading chemists and supermarkets but this means moving someone else's products off the shelves! So the challenge is to get stores to stock your

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products; this may be achieved by good negotiating skills and offering appropriate incentives. The distributors used will determine the final price of the product and how it is presented to the end customer. When selling via retailers, for example, the retailer has control over where the products are displayed, how they are priced, and how much they are promoted in-store. You can also gain a competitive advantage by using changing distribution channels. Banks, insurance companies, holiday firms, hotels, and many others businesses have seen the opportunities created by the internet. Direct Line insurance, Dell computers and Amazon have reduced costs by selling direct. Some firms such as Betterware and Avon have used alternative distribution channels to their competitors by selling door to door; Ann Summers' products have sold well via parties.

- *Customers:* customers are obviously the key to sales. Managers must monitor customer needs and try to anticipate how these will develop so that they can meet these requirements effectively now and in the future. To help understand their customers firms are increasingly trying to gather information on them through mechanisms such as loyalty cards. By gathering data on shopping patterns and matching this to data on the individual shoppers firms can build up detailed pictures of their buyers and then offer them appropriate deals. Many firms are also trying to develop relationships with customers to help ensure they come back time and time again. Loyalty cards, frequent flyer programmes, and frequent shopper incentives are all aimed at rewarding customers who buy a firm's product regularly. Newsletters, email lists, and recommendations to online shoppers of what else they might be interested in are all ways of trying to build a relationship with customers. Of course, potential buyers usually have many choices and so may be able to use their bargaining power in relation to firms. The growth of the internet has enabled customers to search quickly for alternatives and compare deals more easily; this puts pressure on firms to provide better value for money or they will lose their customers.

- *Competition*: the success and behaviour of any business will depend on the degree of competition in its market. In some markets one firm is dominant. This is called a monopoly. Technically in the UK a monopoly exists when a firm has a market share of over 25%. If you are in a monopoly position this may allow you to exploit the consumer with relatively high prices (assuming your position is protected in some way) and you may be able to offer an inferior service if customers have no other choices. In other markets a few firms dominate; this type of market structure is called an oligopoly. In oligopolistic markets there is a high degree of interdependence and so firms will think carefully how their rivals might react to any actions they take. This can lead to an emphasis on non price competition; a price change is relatively easy to imitate and so firms may rely more on methods such as branding or product development. Oligopolies exist in many markets in the UK such as insurance, banking, car manufacturing, supermarkets. In more competitive markets where there are many firms providing similar products customers have more choice; this may put downward pressure on prices and means that excellent customer service is essential.

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Porter's Five Forces analysis of market structure

The competitive structure of an industry can be analysed using Porter's five forces.

This model attempts to analyse the attractiveness of an industry by considering five forces within a market.

According to Porter (1980) the likelihood of firms making profits in a given industry depends on five factors:

1. The likelihood of new entry i.e. the extent to which barriers to entry exist. The more difficult it is for other firms to enter a market the more likely it is that existing firms can make relatively high profits.

The likelihood of entering a market would be lower if:

- the entry costs are high e.g. if heavy investment is required in marketing or equipment
- there are major advantages to firms that have been operating in the industry already in terms of their experience and understanding of how the market works (this is known as the "learning effect")
- government policy prevents entry or makes it more difficult; for example, protectionist measures may mean a tax is placed on foreign products or there is a limit to the number of overseas goods that can be sold. This would make it difficult for a foreign firm to enter a market
- the existing brands have a high level of loyalty
- the existing firms may react aggressively to any new entrant e.g. with a price war
- the existing firms have control of the supplies e.g. entering the diamond industry might be difficult because the majority of known sources of diamonds are controlled by companies such as De Beers.

2. The power of buyers.
The stronger the power of buyers in an industry the more likely it is that they will be able to force down prices and reduce the profits of firms that provide the product.

Buyer power will be higher if:

- there are a few, big buyers so each one is very important to the firm
- the buyers can easily switch to other providers so the provider needs to provide a high quality service at a good price
- the buyers are in position to take over the firm. If they have the resources to buy the provider this threat can lead to a better service because they have real negotiating power

3. The power of suppliers.
The stronger the power of suppliers in an industry the more difficult it is for firms within that sector to make a profit, because suppliers can determine the terms and conditions on which business is conducted.

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Suppliers will be more powerful if

- there are relatively few of them (so the buyer has few alternatives)
- switching to another supplier is difficult and/or expensive
- the supplier can threaten to buy the existing firms so is in a strong negotiating position

4. The degree of rivalry
This measures the degree of competition between existing firms. The higher the degree of rivalry the more difficult it is for existing firms to generate high profits.

Rivalry will be higher if:

- there are a large number of similar sized firms (rather than a few dominant firms) all competing with each other for customers
- the costs of leaving the industry are high e.g. because of high levels of investment. This means that existing firms will fight hard to survive because they cannot easily transfer their resources elsewhere
- the level of capacity utilization. If there are high levels of capacity being underutilized the existing firms will be very competitive to try and win sales to boost their own demand
- the market is shrinking so firms are fighting for their share of falling sales
- there is little brand loyalty so customer are likely to switch easily between products

5. The substitute threat.
This measures the ease with which buyers can switch to another product that does the same thing e.g. aluminium cans rather than glass or plastic bottles. The ease of switching depends on what costs would be involved (e.g. transferring all your data to a new database system and retraining staff could be expensive) and how similar customers perceive the alternatives to be.

Using Porter's analysis firms are likely to generate higher returns if the industry:

- Is difficult to enter
- There is limited rivalry
- Buyers are relatively weak
- Suppliers are relatively weak
- There are few substitutes.

On the other hands returns are likely to be low if:

- The industry is easy to enter
- There is a high degree of rivalry between firms within the industry
- Buyers are strong
- Suppliers are strong
- It is easy to switch to alternatives

The implication of Porter's analysis for managers is that they should examine these five factors before choosing an industry to move into. They should also consider ways of changing the five factors to make them more favourable.

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For example:

- if firms merge together this can reduce the degree of rivalry. This has happened a great deal in industries such as automobiles, pharmaceuticals, and banking where firms have joined together to remove competitors
- if firms buy up distributors (this is called forward vertical integration) they can gain more control over buyers
- if firms differentiate their product perhaps by trying to generate some form of Unique Selling Proposition (USP) that makes it stand out from the competition. This lies at the heart of many marketing and brand building activities. Coca Cola, for example, has fought hard to promote itself as "the real thing"; everything else is just imitation!
- if they react aggressively to a firm that enters its market this may deter potential entrants in the future

The five forces will change over time as market conditions alter. For example, more information is available nowadays to enable customers to compare offerings and prices; this gives buyers more power. The opening up of world markets (for example through the efforts of the World Trade Organization to reduce protectionist measures that limit trade, and the expansion of the European Union enabling free trade between more countries) has led to much more rivalry in markets in recent years. In North America, for example, the sales of Japanese firms such as Toyota have gradually been reducing the market share of American producers such as General Motors as consumers have more choice. Meanwhile, the success of the internet has made it easier for producers to enter many markets such as finance, book retailing, and clothes retailing; the ability to start selling online has reduced a major barrier to entry which was the investment required to set up a network of shops. As ever, the business world is not static and the conditions in any industry will always be changing. As this happens the various elements of the five forces are always shifting requiring established firms and potential entrants to review their strategies.

PESTEL analysis of the macro-environment

There are many factors in the macro-environment that will affect the decisions of the managers of any organization. Tax changes, new laws, trade barriers, demographic change, and government policy changes are all examples of macro change. To help analyse these factors managers can categorize them using the PESTEL model. This classification distinguishes between:

- *Political factors*. These refer to government policy such as the degree of intervention in the economy. What goods and services does a government want to provide? To what extent does it believe in subsidizing firms? What are its priorities in terms of business support? Political decisions can impact on many vital areas for business such as the education of the workforce, the health of the nation, and the quality of the infrastructure of the economy such as the road and rail system.

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- *Economic factors.* These include interest rates, taxation changes, economic growth, inflation, and exchange rates. As you will see throughout the *Foundations of Economics* book, economic change can have a major impact on a firm's behaviour. For example:
    - higher interest rates may deter investment because it costs more to borrow
    - a strong currency may make exporting more difficult because it may raise the price in terms of foreign currency
    - inflation may provoke higher wage demands from employees and raise costs
    - higher national income growth may boost demand for a firm's products

- *Social factors.* Changes in social trends can impact on the demand for a firm's products and the availability and willingness of individuals to work. In the UK, for example, the population has been ageing. This has increased the costs for firms who are committed to pension payments for their employees because their staff are living longer. It also means some firms, such as Asda, have started to recruit older employees to tap into this growing labour pool. The ageing population also has impact on demand: for example, demand for sheltered accommodation and medicines has increased whereas demand for toys is falling.

- *Technological factors:* new technologies create new products and new processes. MP3 players, computer games, online gambling, and high definition TVs are all new markets created by technological advances. Online shopping, bar coding, and computer aided design are all improvements to the way we do business as a result of better technology. Technology can reduce costs, improve quality, and lead to innovation. These developments can benefit consumers as well as the organizations providing the products.

- *Environmental factors:* environmental factors include the weather and climate change. Changes in temperature can impact on many industries including farming, tourism, and insurance. With major climate changes occurring due to global warming and with greater environmental awareness this external factor is becoming a significant issue for firms to consider. The growing desire to protect the environment is having an impact on many industries, such as the travel and transportation industries (for example, more taxes being placed on air travel and the success of hybrid cars), and the general move towards more environmentally friendly products and processes is affecting demand patterns and creating business opportunities.

- *Legal factors:* these are related to the legal environment in which firms operate. In recent years in the UK there have been many significant legal changes that have affected firms' behaviour. The introduction of age discrimination and disability discrimination legislation, an increase in the minimum wage, and greater requirements for firms to recycle are examples of relatively recent laws that affect an organization's actions. Legal changes can affect a firm's costs (e.g. if new

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systems and procedures have to be developed) and demand (e.g. if the law affects the likelihood of customers buying the good or using the service).

Different categories of law include:

- consumer laws; these are designed to protect customers against unfair practices such as misleading descriptions of the product
- competition laws; these are aimed at protecting small firms against bullying by larger firms and ensuring customers are not exploited by firms with monopoly power
- employment laws; these cover areas such as redundancy, dismissal, working hours, and minimum wages. They aim to protect employees against the abuse of power by managers
- health and safety legislation; these laws are aimed at ensuring the workplace is as safe as is reasonably practical. They cover issues such as training, reporting accidents, and the appropriate provision of safety equipment

Typical PESTEL factors to consider include:

Factor	**Could include:**
Political	e.g. EU enlargement, the euro, international trade, taxation policy
Economic	e.g. interest rates, exchange rates, national income, inflation, unemployment, Stock Market
Social	e.g. ageing population, attitudes to work, income distribution
Technological	e.g. innovation, new product development, rate of technological obsolescence
Environmental	e.g. global warming, environmental issues
Legal	e.g. competition law, health and safety, employment law

By using the PESTEL framework we can analyse the many different factors in a firm's macro environment. In some cases particular issues may fit in several categories. For example, the creation of the Monetary Policy Committee by the Labour government in 1997 as a body that was independent of government but had the ability to set interest rates was a political decision but has economic consequences; meanwhile government economic policy can influence investment in technology via taxes and tax credits. If a factor can appear in several categories managers simply make a decision of where they think it best belongs.

However, it is important not to just list PESTEL factors because this does not in itself tell managers very much. What managers need to do is to think about which factors are most likely to change and which ones will have the greatest impact on them, i.e. each firm must identify the key factors in their own environment. For some, such as pharmaceutical companies, government regulation may be critical; for others, perhaps firms that have borrowed heavily, interest rate changes may be a huge issue. Managers must decide on the relative importance of various factors and one way of doing this is to rank or score the likelihood of a change occurring and also rate the impact if it did. The higher the likelihood

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of a change occurring, and the greater the impact of any change, the more significant this factor will be to the firm's planning.

It is also important when using PESTEL analysis to consider the level at which it is applied. When analysing companies such as Sony, Chrysler, Coca Cola, BP, and Disney it is important to remember that they have many different parts to their overall business - they include many different divisions and in some cases many different brands. Whilst it may be useful to consider the whole business when using PESTEL in that it may highlight some important factors, managers may want to narrow it down to a particular part of the business (e.g. a specific division of Sony); this may be more useful because it will focus on the factors relevant to that part of the business. They may also want to differentiate between factors which are very local, other which are national, and those which are global.

For example, a retailer undertaking PESTEL analysis may consider:

- *Local factors* such as planning permission and local economic growth rates
- *National factors* such as UK laws on retailer opening hours and trade descriptions legislation and UK interest rates
- *Global factors* such as the opening up of new markets making trade easier. The entry of Bulgaria and Rumania into the European Union might make it easier to enter that market in terms of meeting the various regulations and provide new expansion opportunities. It might also change the labour force within the UK and recruitment opportunities.

This version of PESTEL analysis is called LoNGPESTEL. This is illustrated below:

	LOCAL	**NATIONAL**	**GLOBAL**
POLITICAL	Provision of services by local council	UK government policy on subsidies	World trade agreements (e.g. further expansion of the EU)
ECONOMIC	Local income	UK interest rates	Overseas economic growth
SOCIAL	Local population growth	Demographic change (e.g. ageing population)	Migration flows
TECHNOLOGICAL	Improvements in local technologies e.g. availability of Digital TV	UK wide technology (e.g. UK online services)	International technological breakthroughs e.g. internet
ENVIRONMENTAL	Local waste issues	UK weather	Global climate change
LEGAL	Local licences/planning permission	UK law	International agreements on human rights or environmental

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			policy

In *Foundations of Economics* we focus on the economic environment. We examine issues such as the effect of interest rate changes, changes in exchange rates, changes in trade policy, government intervention in an economy via spending and taxation, and economic growth rates. These can be incredibly important factors in a firm's macro-environment. The growth of China and India, for example, has had massive effects on many organizations. Firms can relocate production there to benefit from lower costs; these emerging markets are also providing enormous markets for firms to aim their products at. With a population of over 1 billion, for example, the Chinese market is not one you would want to ignore; at the same time Chinese producers should not be ignored either. However, the relative importance of economic factors compared to other factors will depend on the particular position of a business. Exchange rate fluctuations may be critically important to a multinational but less significant to a local window cleaner. Rapid economic growth or economic decline may be very significant to a construction business that depends heavily on the level of income in the economy but may be slightly less significant to a milk producer whose product is less sensitive to income. So whilst the economy is important to all firms on both the supply side (e.g. unemployment levels affect the ease of recruitment) and demand side (e.g. income tax affects spending power) the relative importance of specific economic factors and the relative importance of the economy compared to, say, regulation or social trends will vary. Whilst we hope this book provides a good insight into the economy and the possible effects of economic change on a business these must be considered in the light of other macro and micro factors that influence a firms' decisions and success.

Opportunities and Threats

Some changes in the macro environment will create opportunities for a business. The expansion of the European Union has made it easier to export to markets such as Bulgaria and Romania. The boom in China has created a major new market. Other changes may create threats. The growth of the internet has threatened traditional package holiday companies as consumers book directly for themselves; this is why this industry has seen substantial consolidation as firms rationalize to become more efficient. Whether a particular change is an opportunity or threat depends on the specific position of a business- is it able to exploit the opportunities created? Has it anticipated the change already and prepared for it or has it been taken by surprise? Does it have the skills and resources required to meet changing customer needs?

When considering the external changes that may occur and deciding whether they are significant opportunities or threats, managers must consider the internal functions of their business. This process of matching the internal position of a business to the external environment is called SWOT analysis and is examined below.

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Using PESTEL analysis

The external environment is tremendously complex and dynamic. Take your eyes off it for a moment and you may find there has been a significant change in the competitive landscape. This is why PESTEL analysis really needs to be undertaken on a regular basis. However, even then it does not ensure that every significant change will be identified. Have you ever been waiting to meet someone in a crowded place and not noticed they were there until they were almost directly in front of you? You were too busy looking at someone else or for something else (you were sure they would be wearing a particular coat, for example). The same can happen to managers scouring the external environment - there is a lot going on in many different places and it is perfectly possible that they miss the changes that later turn out to be incredibly important. This is particularly likely when people have already decided in their minds what should be happening. They "know" their friend will be coming from a particular direction so that's the only place they look. This is fine if the friend does come from this direction but not so good if he or she chooses a different route. When using PESTEL analysis managers must be prepared to look all around them and question their assumptions!

Influencing the PESTEL environment

For most firms there is little hope of influencing the PESTEL environment on their own, at least on a global scale; they may have more success on a local scale where they might play a relatively important role in the local economy. However, managers will naturally try where they can to shape the external environment in their favour. This may be more feasible through industry associations that are formed to protect their interests and represent a particular sector such as cars or printing. These bodies represent many firms and therefore may have more power than any individual firm when it comes to influencing government. The larger organizations may also have their own public relations departments or agencies and will work with lobbying companies to try and introduce or delay particular forms of legislation. The tobacco companies, for example, fought long and hard to prevent any statements that clearly linked smoking to cancer; they then fought equally hard to limit restrictions of their marketing and on the size of warnings on tobacco products.

Within the UK the Confederation of British Industry (CBI) also represents the interests of British firms in discussions with government on a wide range of issues such as economic policy, Europe, and environmental issues. More information on the CBI can be found at www.cbi.org.uk

Developing a strategy: SWOT analysis

In an earlier part of this section we outlined what was meant by a strategy. We now consider how a strategy may be formed. To determine what their strategy should be managers must consider the internal strengths and weaknesses of their organization and

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compare these with the external opportunities and threats. This process is known as SWOT analysis.

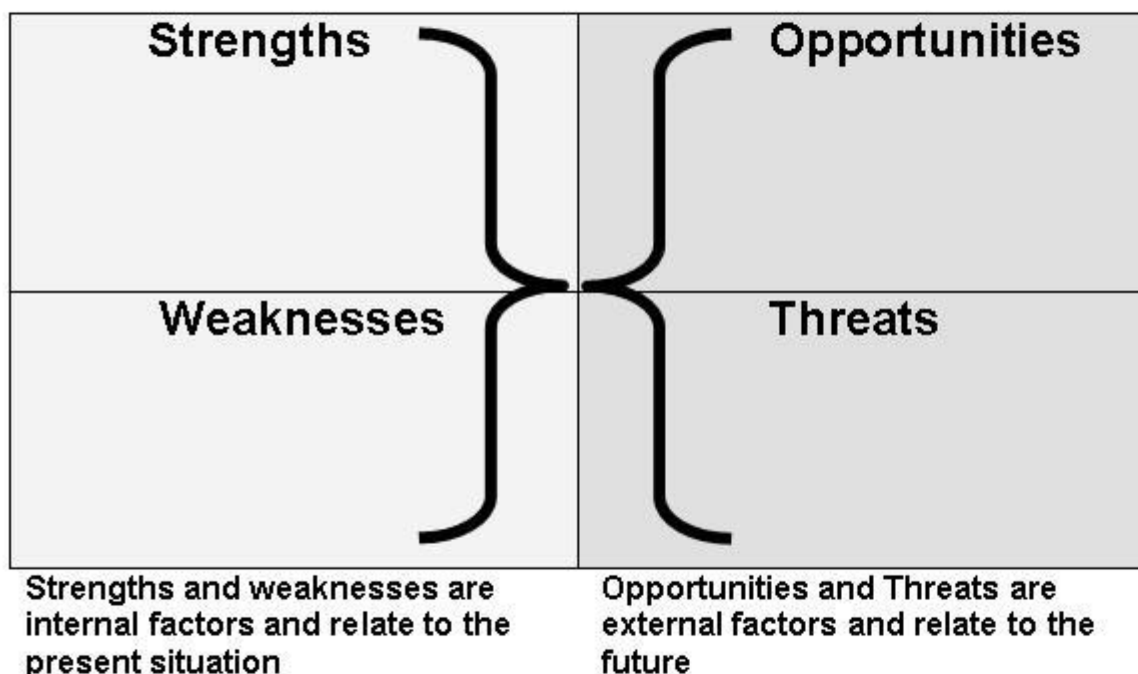
Strengths are internal factors that a firm may build on to develop a strategy. For example, they may include:

- Marketing strengths e.g. a strong brand or access to a good distribution network
- Financial strengths e.g. a high level of cash, access to loan capital if needed, and a good credit rating
- Operations strengths e.g. a high level of efficiency, flexible production systems, and high quality levels
- HRM strengths e.g. a well trained workforce, a creative and motivated workforce, and good employee relations

Weaknesses are internal factors that a firm may need to protect itself against such as:

- Marketing weaknesses such as limited distribution, a poor product range, and ineffective promotion
- Financial weaknesses such as high levels of borrowing and low rates of return
- Operational weaknesses such as old, inefficient equipment and poor quality
- HRM weaknesses such as a high rate of labour turnover and industrial disputes

Managers must identify the specific strengths and weaknesses of their business and rate these according to how significant they are. They should then compare these with the external opportunities and threats identified by PESTEL analysis. This is SWOT analysis.



A strategy may be developed by using a firm's strengths to exploit the opportunities that exist. For example, a strong brand name may be used to extend a firm's products into new

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markets. It may also use these strengths to protect itself against threats; for example, a retailer may use its finance to acquire key locations to prevent a competitor buying them.

A firm may also want to protect itself against its weaknesses. For example, it may try to find alternative suppliers to reduce an over-reliance on a particular one; it may invest in a rebranding exercise to reposition itself.

Undertaking a SWOT analysis effectively is not as easy as it may seem. First managers have to correctly identify what all the relevant factors are and how important each one is. Too often managers have their own perspective on a situation and therefore may only see what they want to see (as with PESTEL analysis). This is known as "perceptual filtering". Kodak's managers spent several years watching other camera manufacturers when they should have been watching consumer electronics firms such as Sony who were developing digital cameras.

Secondly, managers need to work out the most appropriate strategy that combines the strengths and opportunities and actually implement the plan successfully. Putting a plan into action can be more difficult than coming up with it in the first place due to resistance from staff or unexpected problems getting things done.

It is also important to undertake this type of analysis regularly because the competitive landscape and the internal situation will be constantly changing.

The importance of strategy should not be underestimated. Changing the price of an item, changing the distribution strategy, and investing in new equipment are all important decisions but if you are fighting in the wrong market with the wrong products then the details are almost irrelevant. The strategy sets out where and how the battles will be fought and a good strategy is essential to business success. This involves an understanding not only of what happens within the firm but also the ability to forecast changes in the external environment and their significance successfully.

As the internal and external environments change so must a firm's strategy to maintain an appropriate fit. In *Foundations of Economics* you will read about all kinds of economic factors that can change; these will alter a firm's playing field and the rules of the game. This in turn means that managers need to consider carefully what team they pick and how they decide to play the match i.e. as the economy changes the strategy may need to change as well.

Summary

The economy is an important factor influencing business decisions. Economic change can affect costs (e.g. through the minimum wage), the transformation process (e.g. outsourcing production to an emerging economy), and demand (e.g. due to changes in national income). Understanding economic factors, why they matter, and why they might change is therefore an important part of managing a business.

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