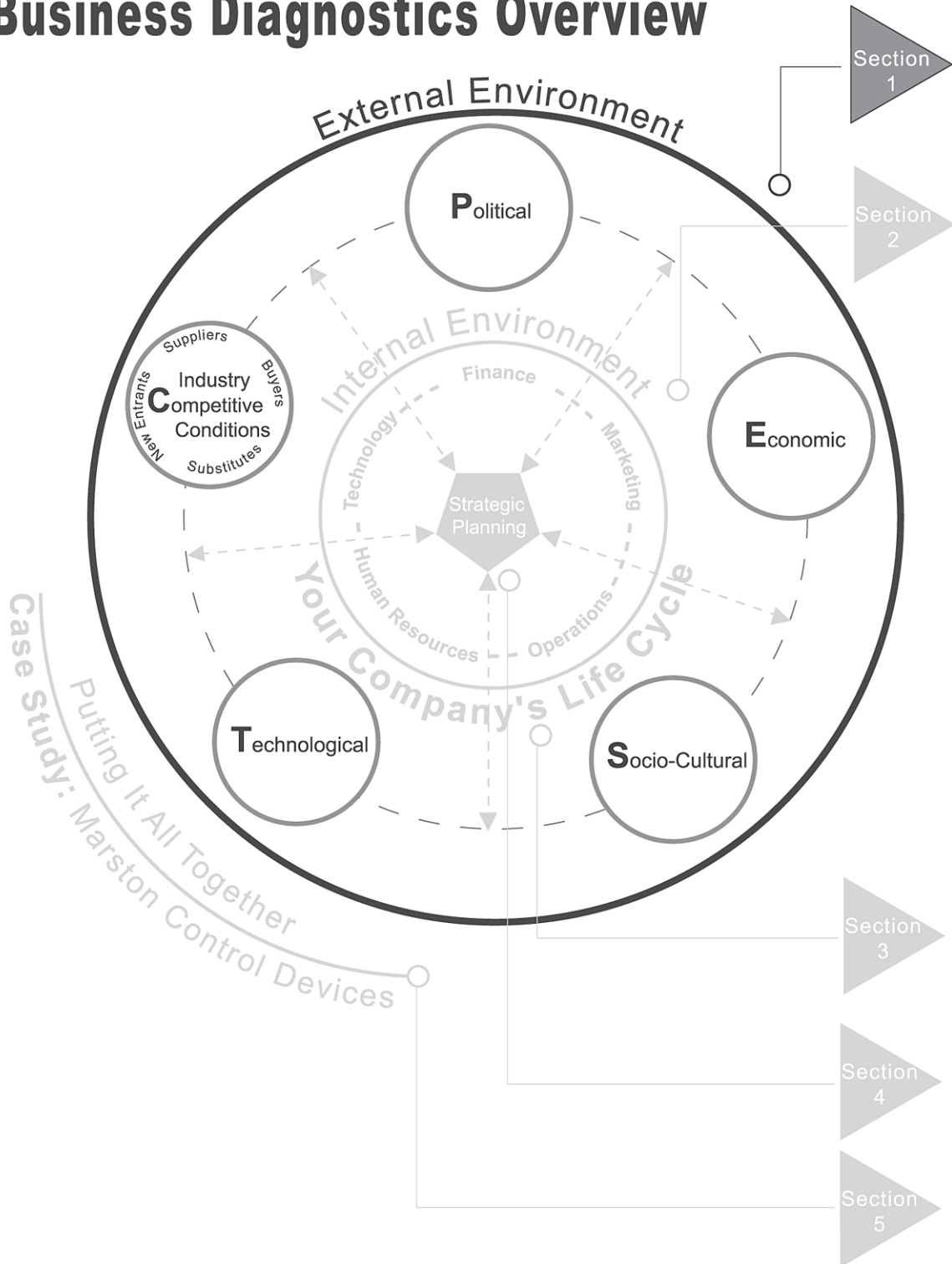


SECTION 1

THE EXTERNAL 'SIZE-UP'

Business Diagnostics Overview



CHAPTER 1

THE BUSINESS ENVIRONMENT

OVERVIEW

A key element of the External Size-Up process is looking at ‘the Big Picture’. The prevailing business environment, recent trends and related industry conditions need to be critically reviewed by company management.

This chapter covers the business environment. Think of it as an outer atmosphere that, while distinct from day to day company operations, exerts a significant impact on the company’s prospects and performance.

A useful tool to assess the Business Environment is a P.E.S.T. analysis, an easy-to-remember acronym that encompasses the following four key areas:

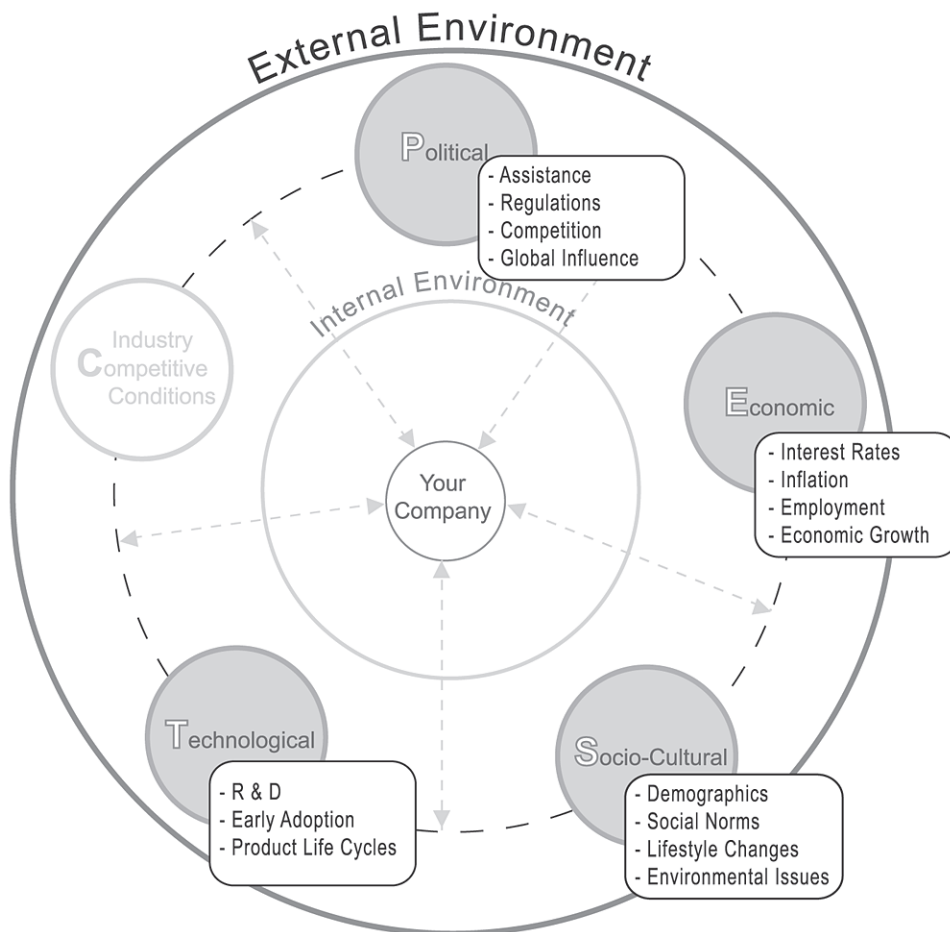
- ♦ Political-Legal Factors
- ♦ Economic Issues
- ♦ Socio – Cultural Trends
- ♦ Technological Considerations

Each key area is reviewed, providing a checklist of issues to consider. While some of these issues are industry specific (i.e. they relate to the industry within which a company operates or plans to operate), the focus of this chapter remains on the big picture.

The P.E.S.T. structure and the impact on an individual company is illustrated in Figure 1-1 below.

Figure 1-1

P.E.S.T. – An Overview



POLITICAL-LEGAL FACTORS

The predominant force here is government influence and legal/regulatory issues, ranging from global entities to federal to provincial/state to municipal or a combination of all four.

You should be aware that governments could:

- Assist you
- Regulate you
- Compete with you
- Globally influence you

Consider your company and the industry in which it operates and then review the following checklist to determine the extent to which government activities influence your business environment. It is also worthwhile to assess the extent of business friendly policies implemented by your provincial/state, federal, or municipal governments.

- Is new legislation pending that may change their approach? What is driving proposed legislative changes?
- Will the political climate change in the near term? Are there pending elections that might affect your business or your industry? What are the potential impacts on your business?
- Are there global or societal trends that could lead to changes government policy or how government acts or reacts internationally that could impact your business?

We have added an additional section – Global Influences, which recognizes the dramatic influence that ‘trans-national’ events, markets and organizations now exert.

GOVERNMENT ASSISTANCE TO BUSINESS

Is government support available for:

- Industrial research?
- Technological innovation?
- Marketing or management advice?
- Productivity advancements?
- Export opportunities?
- Financing?
- Employment programs?

Remember:

If grants or subsidies are available, are they also available to your competitors? Are there any strings attached? How much time will it take you to complete the required paperwork as compared to the benefit of the grant funds?

LEGAL REGULATION OF BUSINESS

Consider how the following regulatory mechanisms might impact your business:

- Taxation: Will reduce your return on investment and may increase or decrease your competitive advantage if your company faces lower or higher tax-rates than your competition?
- Health and safety regulations like OSHA in the U.S.¹ or workplace regulations like Worker's Compensation² in Canada.
- Environmental policies and controls: Are there incentives, fees, penalties, and potential project delays?
- Regulating competition: Examples are the Competition Act³ in Canada or the U.S Antitrust law⁴, which prohibits certain practices, like tied selling, exclusive dealing, discriminatory allowances, etc.
- Consumer protection: Examples would include the Food and Drug Act⁵ in Canada and various laws from the U.S. Food and Drug Administration.⁶
- Investor protection: Various Securities Acts via U.S. Securities and Exchange Commission⁷ and Canadian Securities Administrators⁸ governance compliance requirements.
- Protection of firms' intangible assets: Trademarks, patents, copyrights, and industrial design.

DIRECT COMPETITION WITH BUSINESS

- Government or state owned enterprises (Crown Corporations in Canada) can be unpredictable competitors with deep pockets.
- Privatization of government agencies can intensify competitive pressures by altering traditional buying and selling practices.
- How governments choose to design, build, manage and fund infrastructure projects can often a business' ability to compete. For example, a government's move to use Public, Private Partnerships or P3s may make it more difficult for smaller construction companies to bid on infrastructure projects, work with different funding models and absorb risk.

GLOBAL INFLUENCES

- Significant political events like terrorism, regional wars and conflicts, trade sanctions.
- Emerging new global markets and competitors in Brazil, China, India and Russia.
- Transnational bureaucracies like World Trade Organization (WTO) in Geneva and the European Union institutes in Strasbourg, Frankfurt, Luxembourg and Brussels.

ADDITIONS TO P.E.S.T

Some analysts prefer to use a P.E.S.T.E.L. tool by adding specific environmental and legal sections (or moving the letters around to get various iterations like SLEPT, STEEPLE) or a PEST-C to add competition (or culture). This is a decision based on the individual facts of the company you are analyzing. The PEST tool is typically sufficiently robust to consider these add-on issues.

To round out this review of the external political-legal factors, we would recommend reading *The World Is Flat: A Brief History of the 21st Century* by Thomas Friedman. This book sets out to explain how the ‘flattening’ of the world business ‘playing field’ has evolved through a convergence of technology and the explosion of the middle-class in China and India.

Friedman describes 10 ‘flatteners’ – major political events, innovations and companies that have converged to deliver multiple new tools and processes for collaboration on a global scale.⁹

ECONOMIC ISSUES

The state of the economy has an obvious impact on your business yet many business owners are confused by the overwhelming weight of economic data and information available to them. There are over one hundred economic indicators published on a regular basis by financial and economic analysts and government agencies. This section clarifies key indicators by summarizing six areas of macro economic activity that will impact the business owner.

KEY MACRO ECONOMIC INDICATORS

1. Economic Growth.
2. Price levels (inflation).
3. Interest rates.
4. Employment.
5. Government policy.
6. Global economic influences, notably resource price shocks.

1. ECONOMIC GROWTH

- The primary indicator is Gross Domestic Product (GDP), which measures a country's economic output.
- Recent GDP growth rates of 2-3% in the United States indicate a growing economy after the 2008 recession accompanied by stronger consumer confidence and spending.¹⁰ In Canada, the GDP can be found by going to the Statistics Canada website.¹¹
- Real GDP recognizes that the effect of inflation on price levels has been removed, thereby providing a more accurate fix on actual economic growth.
- Three consecutive (three month) quarters of decline in GDP growth are generally considered to indicate the onset of a recession.

2. PRICE LEVELS

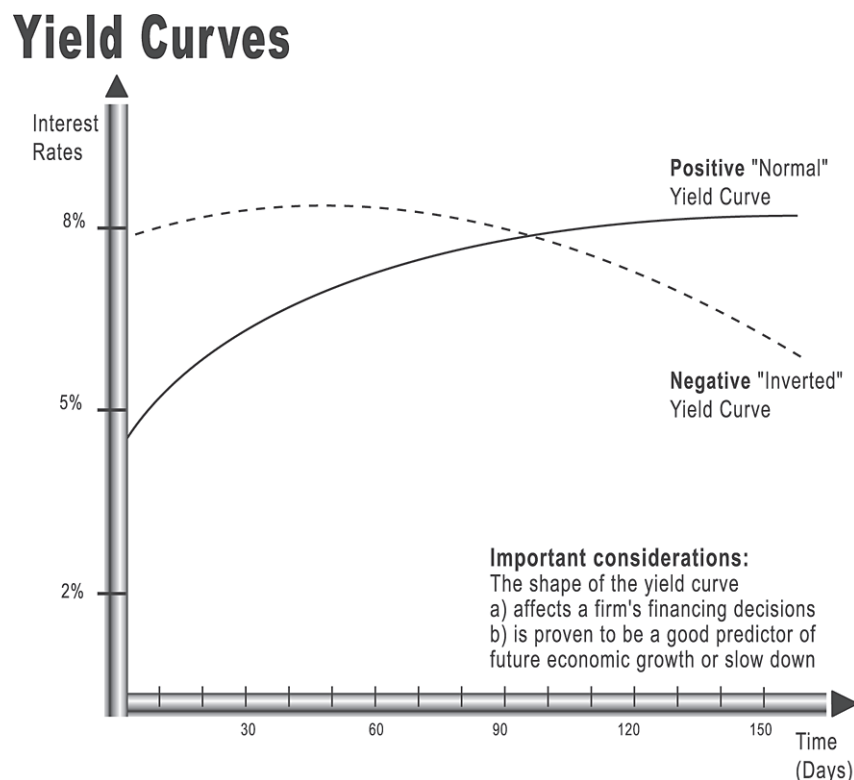
- The prevailing level of price inflation has a crucial effect on consumer confidence along with business revenue and earnings performance.
- The primary indicator is the Consumer Price Index¹² (CPI)¹³ that is the traditional yardstick for tracking inflation.
- The CPI measures the relative price increases of a 'basket' of goods and services. (The index's accuracy has been questioned in the past for its susceptibility to interest rate swings, short-term erratic price fluctuations and the extent to which energy and food costs have been included).
- Inflation can be broadly segmented as follows:
 - i) *Demand Pull*: Prices are 'pulled' up by strong consumer and business demand for goods and services.
 - ii) *Cost Push*: Prices are 'pushed' up by increased raw material and labor costs.

3. INTEREST RATES

- They are a key influence on economic activity. Both short- and long-term rates need to be considered.
- Short-term rates (one to twelve months) are set by the Bank of Canada and/or the U.S Federal Reserve Bank and exert a significant impact on consumer credit and business borrowings.
- Long-term rates (one to twenty years) follow corporate and government bond markets. These rates have a major impact on consumer big-ticket purchases and business expansion/capital expenditure decisions.
- The relationship between short-term and long-term interest rates has historically been defined by a positive yield curve with short-term rates lower than long-term rates (investors require a greater reward to lock in investments for a longer time period).
- An inverted yield curve (short-term rates higher than long-term rates) is often considered to be a precursor to a recession.

Figure 1-2 (below) provides a graphical representation of positive and negative yield curves.

Figure 1-2



- Interest rates may have a significant impact on a company's financial performance and strategies. For example, in a rising interest rate environment, the company's ability to repay debt will be impaired (higher interest costs, less principal paid back).
- Even if an early stage company has been funded by equity (as opposed to debt financing), increasing interest rates will tend to exert a dampening effect on overall economic growth prospects.

4. EMPLOYMENT

- The primary indicator of labor market health is the percentage of the available workforce that is unemployed. This will vary over time and in different countries. In the United States, rates vary from 5 – 6 % level which has increased since 2006.¹⁴ Labor employment rates in Canada can be found at the Statistics Canada website.
- There are significant differences in the kinds of employment experienced by workers and the resulting impact on the economy. Some are:
 - i) *Frictional unemployment*: Workers temporarily out of work.
 - ii) *Cyclical unemployment*: Workers without jobs due to downturns in business cycles (i.e. shipbuilding, auto sector).
 - iii) *Structural unemployment*: People out of work for long periods of time due to lack of skills (e.g. pursuing higher education) or fundamental changes in economic resources (e.g., East Coast fishery).

5. GOVERNMENT ACTIVITIES AND POLICIES

Consider:

- The current levels of direct and indirect taxes and/or fees compared to competitors' countries.
- The potential for transfer payment cutbacks (federal to provincial/state to local governments).
- The level of government spending, which is impacted by current fiscal budget performance.
- The U.S. continues to run massive budget deficits, is starting to cause considerable concern due to the debt being held offshore and primarily in China.

6. GLOBAL ECONOMIC INFLUENCES

Key areas to assess:

- **Currency value:** The relative value of the Canadian versus the US dollar has a major impact on exporters and importers. While short-term fluctuations are difficult to anticipate, longer-term trends can often be identified and hedged against by forward exchange rate contracts available through your bank.
- **Trading arrangements:** Free trade areas versus economies that remain protected by tariffs and quotas. Examples include NAFTA, GATT and the Canada/ European Union (EU) Comprehensive Economic and Trade Agreement (CETA).
- **Global markets:** The rise of monopolistic multinationals with enormous buying power and economies of scale.
- **Preferential treatment:** Countries imposing ‘buy at home’ policies on government departments and agencies to ensure local companies have ‘first-to-market’ opportunities.

SOCIO-CULTURAL TRENDS

While societal and cultural trends take time to unfold, the sheer force and momentum of them may have significant implications for business owners.

Consider the following:

- *Global population trends:* The current world population is 7 billion + with China/India accounting for approx. 2.5 billion and experiencing unprecedented economic growth.
- *Demographics:* The baby boomer generation in North America, born between 1948 and 1962 are now starting to enter their retirement years. How will it affect your marketplace?
- *Psychographics:* Behavioral, lifestyle and psychological factors that impact purchasing patterns (i.e. environmental/sustainability concerns and the growth of unregulated ‘green/natural products’ versus regulated organic products).
- *Ethnic distribution:* In the USA, significant increases in a Hispanic and Asian work-forces are forecast, especially on the West Coast
- *Social changes:*
 - ◆ The blended family. Divorced couples remarrying and blending each other’s children into a new family unit.

- ♦ The rise of consumerism. The needs of consumers (perceived and real) and the importance in serving them with integrity and honesty.
- ♦ Dual income families, no children.
- ♦ Legalization of marijuana.
- *Lifestyle changes:*
 - ♦ Telecommuting and ‘hoffices’ (home based offices).
 - ♦ Early/post retirement issues.
 - ♦ Dual career couples.
 - ♦ Retraining as boomers commence second careers.
 - ♦ Employee mobility to competitors.
 - ♦ Use of smartphones and social media.
- *Work force diversity requirements*
- *Woman, Veteran, First Nations-owned* small and medium-sized businesses
- *Contract employees* arising from past corporate restructurings
- *Environmental awareness:*
 - ♦ Health and safety issues (Aging population and related health care issues).
 - ♦ Climate change.
 - ♦ “Green,” natural, organic, genetically modified products.
 - ♦ International environmental agreements.
 - ♦ Recycling and conservation issues.
 - ♦ Environmental waste clean up.

TECHNOLOGICAL CONSIDERATIONS

It is crucial to follow current technology trends both outside and within your industry segments.

Consider Moore’s Law which stated that while prices keep constant, the processing power of microchips doubled every 18 months with the result that our mobile devices have more memory and are faster than many personal computers only 20 years ago.¹⁵

Early adopters of new technologies often derive greater market share and improved returns on their capital investment.

TECHNOLOGY ISSUES TO REVIEW:

- Using search engines and online resources as a source of data and information – how is your company exploiting opportunities to keep current in your industry and market as a part of your day-to-day operation?
- Use of smartphones and tablets can lead to substantial increases in business productivity and connectivity’ – does this include you? How might you use mobile applications in your business operations? Can you use locating technologies in logistics, supply chain or in client facing operations?
- What are the Research and Development (R&D) requirements for your industry segment? How do your company’s **actual** R&D expenditures compare? Are you falling behind?
- Are you exploiting Business-to-Consumer (B2C) e-commerce? Is your company an electronic buyer or seller or both? How does this impact existing client and supplier relationships?
- How will current technology changes impact your company’s operations:
 - ◆ Search engine optimization (SEO).
 - ◆ Use of social media for customer care or content marketing.
 - ◆ Search engine marketing (SEM) and social media optimization (SMO).
- Product life cycles (likely shorter and shorter).
- Quick and repeatable go-to-market strategies and tactics.
- Fail-fast product development using software tools.
- Minimally viable product techniques using crowd sourcing launches.
- Competitors who are more technology savvy.
- Ability to forge corporate alliances or joint ventures.
- Access to international markets.
- Delivery (just in time) and transportation issues.
- Potential for process improvements and cost savings.
- Ability to anticipate customer needs using on-line listening tools.

USEFUL WEB SITES

www.statcan.ca	StatsCanada - latest economic indicators
www.europa.eu/	European Union
www.nafta.com	NAFTA
www.usitc.gov	U.S. International Trade Commission
www.tradecommissioner.gc.ca/	Canadian Trade Commissioner
www.rdmag.com	Online resources for R&D professionals
www.guardian.co.uk	In depth coverage global PEST issues
www.outsourcing.com	The Outsourcing Institute
www.demographicestimation.iussp.org/	Demographic estimation tool

Notes from text.

- 1 Occupational Health and Safety Administration website www.osha.gov/
- 2 Government of Canada, Labour program website www.labour.gc.ca/eng/health_safety/
- 3 Competition Bureau website www.competitionbureau.gc.ca/
- 4 Federal Trade commission website www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws
- 5 Health Canada website www.hc-sc.gc.ca/fn-an/legislation/acts-lois/act-loi_reg-eng.php
- 6 U.S Food and Drug Administration website www.fda.gov/
- 7 Securities and Exchange Commission website www.sec.gov/
- 8 Canadian Securities Administrators website www.securities-administrators.ca/
- 9 Thomas Friedman – The World is Flat: A Brief History of the 21st Century’.
- 10 See the U.S. Department of Commerce, Bureau of Economic Analysis website for up to date statistics www.bea.gov/
- 11 Statistics Canada website www.statcan.gc.ca/
- 12 In the United States, see United States Department of Labor website www.bls.gov/cpi/
- 13 See Bank of Canada website for Consumer Price Index www.bankofcanada.ca/
- 14 See Bureau of Labor Statistics website www.bls.gov/cps/cps_htgm.htm
- 15 There are some like physicist Michio Kaku who theorize that Moore’s Law will slow down based on the theoretical limits of silicon.