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Porter's Five Forces

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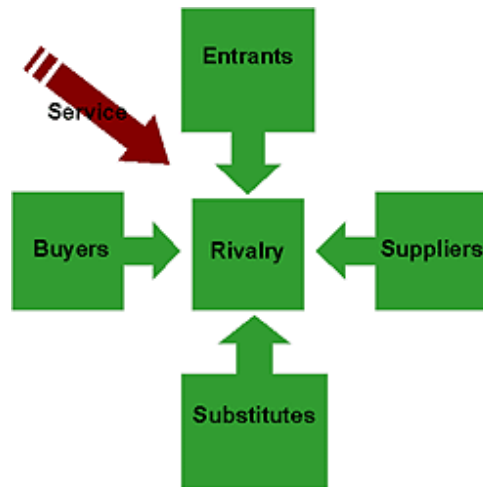
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Understanding the dynamics of competitors within an industry is critical for several reasons. First, it can help to assess the potential opportunities for your venture, particularly important if you are entering this industry as a new player. It can also be a critical step to better differentiate yourself from others that offer similar products and services. One of the most respected models to assist with this analysis is Porter's Five Forces Model. This model, created by Michael E. Porter and described in the book "*Competitive Strategy: Techniques for Analyzing Industries and Competitors*", has proven to be a useful tool for both business and marketing-based planning.

Background

The pure competition model does not present a viable tool to assess an industry. Porter's Five Forces attempts to realistically assess potential levels of profitability, opportunity and risk based on five key factors within an industry. This model may be used as a tool to better develop a strategic advantage over competing firms within an industry in a competitive and healthy environment. It identifies five forces that determine the long-run profitability of a market or market segment.

- Suppliers
- Buyers
- Entry/Exit Barriers
- Substitutes
- Rivalry



Supplier Power

- Supplier concentration
- Importance of volume to supplier
- Differentiation of inputs
- Impact of inputs on cost or differentiation
- Switching costs of firms in the industry
- Presence of substitute inputs
- Threat of forward integration
- Cost relative to total purchases in industry

Buyer Power

- Bargaining leverage
- Buyer volume
- Buyer information
- Brand identity
- Price sensitivity
- Threat of backward integration
- Product differentiation
- Buyer concentration vs. industry
- Substitutes available
- Buyers' incentives

Entry/Exit Barriers

- Absolute cost advantages
- Proprietary learning curve
- Access to inputs
- Government or other binding policy
- Economies of scale
- Capital requirements
- Brand identity
- Switching costs
- Access to distribution
- Expected retaliation
- Proprietary products

Substitutes

- Switching costs
- Buyer inclination to find alternatives
- Price-performance
- Trade-off of the available substitute products or services

Rivalry

- Exit barriers
- Industry concentration
- Fixed costs
- Perceived value add
- Industry growth
- Overcapacity status
- Product differences
- Switching costs
- Brand identity
- Diversity of rivals
- Corporate stakes

Service

- Level of service compared to others
- Added value perceptions

- Dynamics with other attributes

Power of Suppliers

An industry that produces goods requires raw materials. This leads to buyer-supplier relationships between the industry and the firms that provide the raw materials. Depending on where the power lies, suppliers may be able to exert an influence on the producing industry. They may be able to dictate price and influence availability. A segment is unattractive when an organization's suppliers have the ability to:

- Increase prices without suffering from a decrease in volume
- Reduce the quantity supplied
- Organize in a formal or informal manner
- Compete in an environment with relatively few substitutes
- Provide a product/material that is a critical part of the end product or service
- Impose switching costs on their customers when they depart
- Integrate downstream by purchasing or controlling the distribution channels.

One example of this is DeBeers ability to wield influence within the diamond industry. DeBeers' high level of control over some of the most productive diamond mines in the world gives them extreme power within the industry.

The best defense in mitigating the power of suppliers is to build win-win relationships with suppliers or arrange to use multiple suppliers.

Power of Buyers

The power of buyers describes the impact customers have on an industry. When buyer power is strong, the relationship to the producing industry becomes closer to what economists term a **monopsony**. A Monopsony is a market where there are many suppliers and one buyer. Under these market conditions, the buyer has the most influence in determining the price. Few pure monopsonies actually exist, but there is often a connection between an industry and buyers that determines where power lies.

The bargaining power of buyers increases when they have the ability to:

- Be "organized" in some form with others providing similar products and services
- Purchase a product that represents a significant fraction of the buyer's costs
- Buy a product that is undifferentiated
- Incur low switching costs when they change vendors

- Be price sensitive, with other options available
- Integrate upstream, to purchase the providers of the goods.

To mitigate the power of buyers, sellers can seek to select buyers with less power to negotiate, switch suppliers, or develop superior offers that strong buyers cannot refuse.

Barriers to Entry/Exit

The possibility of new firms entering the industry impacts competition. A key is to assess how easy it is for a new player to enter an industry. The most attractive segment has high entry barriers and low exit barriers. Although any firm should be able to enter and exit a market, each industry often presents varying levels of difficulty, commonly driven by economics. Manufacturing-based industries are more difficult to enter than many service-based industries. The definable characteristics of each industry protect profitable areas for firms and inhibit additional rivals from entering the market. These inhibitive characteristics are referred to as **barriers to entry**.

Barriers to entry are more than the expected ebb and flow that markets typically experience. For example, when industry profits increase, one would expect firms to enter the market to take advantage of the high profit levels, which will eventually result in reducing profits.

Conversely, when profits decrease, we would expect some firms to exit. Other factors that will deter new entrants are falling prices, actions that keep prices artificially low, expectations that future prices will fall, large or unpredictable start-up expenditures, and other extreme uncertainties.

Barriers to entry are unique characteristics to each industry. They reduce the rate of entry of new firms and, therefore, maintain a level of profits for current industry competitors. Barriers to entry can be created or exploited to enhance a firm's competitive advantage.

Barriers to entry arise from several sources:

- Patents and proprietary knowledge
- Asset specificity – (Specialized technology or infrastructure)
- Economies of scale
- Government.

Barriers to exit work similarly to barriers to entry. Exit barriers limit the ability of a firm to leave the market and can exacerbate rivalry – unable to leave the industry, a firm must compete. Some of an industry's entry and exit barriers can be summarized as follows: Profitability potential is high when both entry and exit

barriers are high. In this situation, firms do face more risk because poorer-performing ones tend to continue to produce regardless of profitability and, therefore, continue to add to the supply.

Substitute Products Porter's Five Forces model refers to "substitute products" as those products that are available in other industries that meet an identical or similar need for the end user. As more substitutes become available and affordable, the demand becomes more elastic since customers have more alternatives. Substitute products may limit the ability of firms within an industry to raise prices and improve margins.

For example, the price of aluminum cans is constrained by the price of glass bottles, steel cans, and plastic containers. These containers are substitutes, yet they are not rivals in the same industries. A substitute product to the services offered by a CPA firm is accounting or tax-based software – two very different industries that offer some of the same consumer benefits.

The threat of substitutes often impacts price-based competition. There are other concerns in assessing the threat of substitutes relating to technology. New technologies contribute to competition through substitute products and services. Think of the impact wireless technologies have had on traditional telephone service. Except in remote areas it is unlikely that cable TV could compete with free broadcast TV from an antenna without the greater diversity of entertainment that it affords the customer.

Again, a segment is unattractive when there are actual or potential substitutes for a product.

Rivalry

Firms strive to secure a competitive advantage over their rivals. The intensity of rivalry varies within each industry and these differences can be important in the development of strategy.

Industries that are "concentrated," versus "fragmented," often display the highest level of rivalry. Many, including The US Bureau of Census, recognize industry concentration and measure it by the "concentration ratio" (CR). The Census Bureau reports the CR by Standard Industrial Classification (SIC) Code and it indicates the percent of market share held by the four largest firms. A high concentration ratio indicates that a majority of market share is controlled by the largest firms. If a few firms hold a large market share, the competitive landscape is less competitive as it nears that of a monopoly. A low CR indicates that the industry has many rivals, none with significant market share. These fragmented markets are said to be competitive.

In pursuing an advantage over its rivals, a firm can choose from several competitive moves:

- Changing prices
- Improving product differentiation
- Creatively using channels of distribution
- Exploiting relationships with suppliers.

For example, the intensity of rivalry is increased by the following industry characteristics:

- Numerous competitors that are particularly strong or aggressive that are competing for the same customers and resources
- Declining sales revenues and volumes resulting in slow market growth, creating the need to actively fight for market share
- High fixed costs result in an economy of scale effect
- High storage costs or highly perishable products
- Plant capacity is being added, over and above what is needed to meet demand
- Low switching costs for buyers
- Low levels of product differentiation
- Strategic stakes are high when a firm is losing market position or has potential for great gains
- High exit barriers place a significant cost on abandoning the product
- A diversity of rivals with different cultures, histories, and philosophies
- An industry shakeout
- When a rival acts in a way that elicits a counter-response by other firms
- Competitors have high stakes – economic and other – and will battle to remain as a player within the segment.

These conditions will make competing within the industry more challenging, commonly leading to frequent price wars, advertising battles, and the addition of new products.

Service

Service can also play a part in the industry's dynamics. Those competitors that provide superior service may bring an advantage to their competitive position if the industry/customer places value on this attribute. This is another point of differentiation and can be a key strategic element to consider. If a competitor has a service component that is difficult to replicate, it will prove to offer a strategic advantage.

The Result

We can look at several industries and see how Porter's Five Forces would depict them; the entertainment industry is in flux, telecommunications companies are volatile, computer firms are merging, utility industries

are down, the housing market is up. Porter's Five Forces can assist us to better understand these dynamics in a more objective manner and hopefully make better strategic decisions as a result.

About the Author

Doug Wilson is an author, professor, marketing expert, and one of the authors of the software package