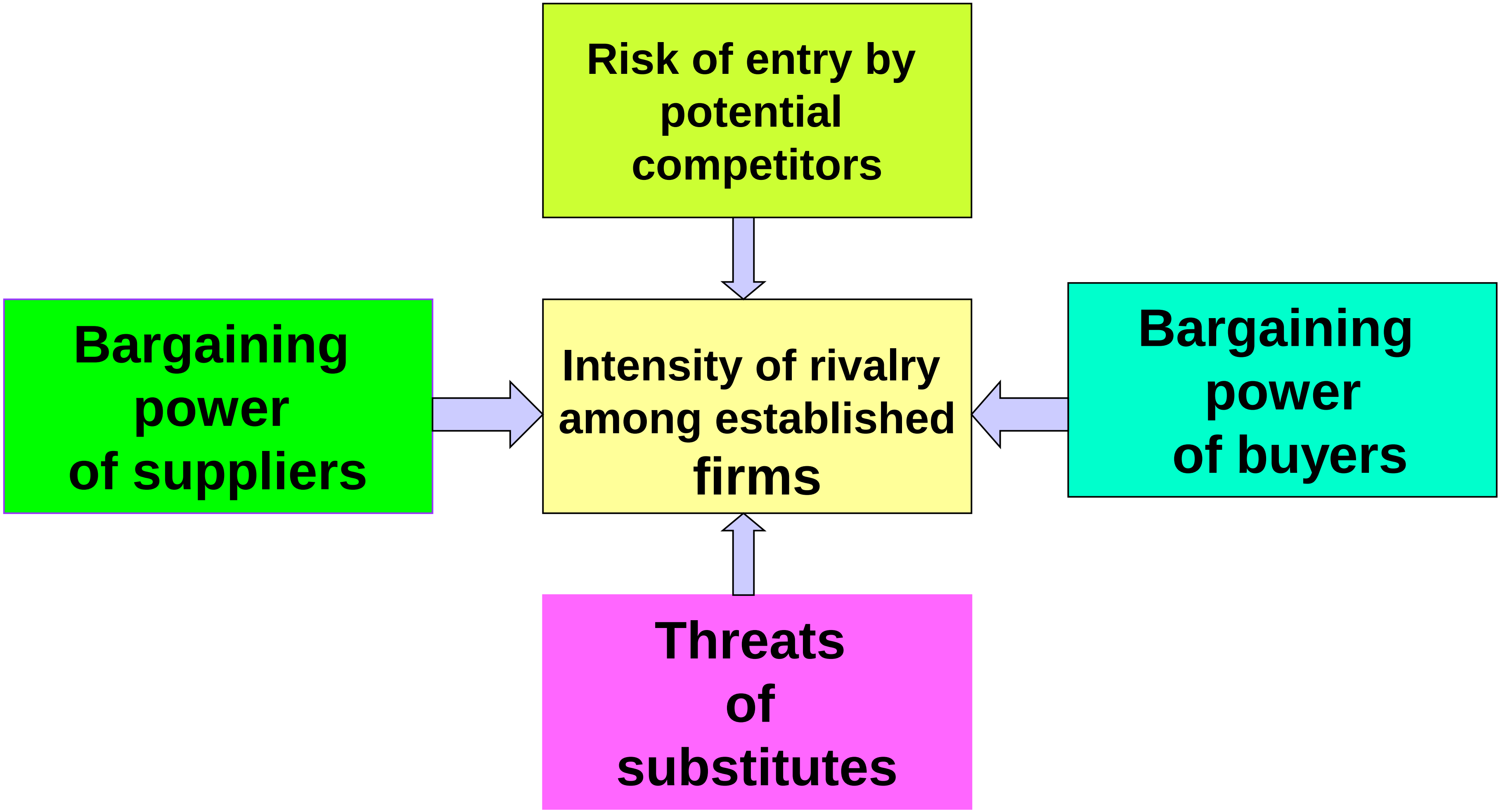
Porter’s five forces model



Risk of entry by potential competitors

Main sources of barriers to entry-

- **Economies of scale:** EOS arise when unit costs falls as a firm expands its output. Sources of scale economies-
  - **Costs reduction gained through mass-producing a standard output.**
  - **Discounts on bulk purchases of raw material inputs and component parts.**
  - **The advantages gained by spreading fixed production costs over a large production volume.**
  - **The cost savings associated with spreading marketing and advertising costs over a large volume of output.**

If the cost advantages from economies of scale are significant, a new company that enters the industry and produces on a small scale suffers a significant cost disadvantages relative to established companies.

Brand loyalty

Brand loyalty exists when consumers have preference for the products of established companies. A company can create brand loyalty through-

- **continuous advertising** of its brand-name products and company name,
- **patent protection** of products.
- **product innovation** achieved through R&D programs,
- An emphasis on **high product quality**, and
- good **after-sales service**.

Significant brand loyalty makes it difficult for new entrants to take market share away from established companies.

Absolute cost advantages

Sometimes established companies have an absolute cost advantage relative to potential entrants, meaning that entrants can not expect to match the established companies lower cost structure. It arise from three main sources-

- **Superior production operations and processes** due to accumulated experience, patents or secret processes.
- **Control of particular inputs required for production**, such as labor, materials, equipment, or management skills, that are limited in their supply.
- **Access to cheaper funds** because existing companies represent lower risks than new entrants.

Customer switching cost

Switching costs arise when it costs a customer **time**, **energy**, and **money** to switch from the products offered by one established company to the products offered by a new entrants.

When switching costs are high, customers can be locked in to the products of established companies, **even if new entrants offer better products**

Government regulation

Historically, government regulation has constituted a major entry barrier into many industries.

- **If established companies** have built brand loyalty for their products, have an absolute cost advantage with respect to potential competitors, having significant economies of scale, are the beneficiaries of high switching costs, or enjoy regulatory protection, the risk of entry by potential competitors is greatly diminished. It is a weak competitive forces.

  Consequently, established companies **can charge higher prices**, and **industry profits are higher**.

- **Evidence from academic research** suggest that **the height of barriers** to entry is one of the most important determinants **of profit rates in an industry.**

- Clearly, it is in the interest of established companies to pursue strategies consistent with raising entry barriers to secure these profits. By the same time, potential new entrants have to find strategies that allow them to circumvent barriers to entry.

The bargaining power of buyers

Under what circumstances buyers are most powerful-

- Suppliers are many and buyers are large and few in number.
- Buyers purchase in large quantities.
- Suppliers depend on buyers for large percentage of its order.
- When switching cost are low.
- Buyers roaming to different suppliers to purchase the products or services.
- Buyers threats to enter into the industry.

Rivalry among established companies-1

The intensity of rivalry among established companies within an industry is largely a function of three factors-

Industry competitive structure

The competitive structure of an industry refers to the number and size distribution of companies in it, something that strategic managers determine at the beginning of an industry analysis. Industry structure vary and different structures have different implications for the intensity of rivalry.

Rivalry among established companies-2

- **Industry demand**

The level of industry demand is a second determinant of the intensity of rivalry among established companies. Growing demand from new customers or additional purchases by existing customers tend to moderate competition by providing greater scope for companies to compete for customer.

Growing demand tends to reduce rivalry because all companies can sell more without taking market share away from others.

Declining demand results in more rivalry as companies fight to maintain market share and revenues.

Rivalry among established companies-3

- **Exit barriers**

Exit barriers are economic, strategic and emotional factors that prevent companies from leaving an industry. If exit barriers are high, companies become locked into an unprofitable industry where overall demand is static or declining.

Common exit barriers including the following-

1. Investment in assets such as specific machine, equipment and operating facilities that are of little or no value in alternative uses or can not be sold off.

2. High fixed cost of exit, such as the severance pay, health benefits and pensions that have to be paid to workers who are being made redundant when a company ceases to operate.

Exit barriers-2

3. Emotional attachments to an industry, as when a company's owners or employees are unwilling to exit from an industry for sentimental reasons or because of pride.

4. Economic dependence on the industry because a company relies on a single industry for its revenue and profit.

5. The need to maintain an expensive collection of assets at or above some minimum level in order to participate effectively in the industry.

The bargaining power of suppliers

Suppliers are most powerful in these situations-

- Few substitutes of products.
- Less important to the suppliers.
- Dependency over suppliers regarding some unique items.
- Suppliers' threats to enter into customer's industry.
- Companies as customer less afford to threat to the suppliers industry part.

- ## Threats of substitutes

Substitute products are those of industries that serve consumers needs in a way that is similar to those being served by the industry being analyzed. Coffee industry/tea industry/soft drink.

If an industry's products have few close substitutes, so that substitute are a weak competitive force.

- ## Threats of complementors (according to Andrew grove)

Complementors are companies that sell products that add value to (complement) the products of companies in an industry because when used together, the products better satisfy customer demands.

The macro environmental forces

- **Economic forces:**
  - Economic forces affect the general health and well being of a nation or the regional economy of an organization, which in turn affect companies and industries ability to earn an adequate rate of return. Four most important factors-
    - **growth rate-**
    - **interest rates,**
    - **currency exchange rates, and**
    - **inflation or (deflation)**

- Technological forces
- Global forces
- Demographic forces
- Social forces
- Political and legal forces

- **Economic growth:** The rate of expansion, from time to time, in the volume of production of goods and services of a country. It commonly expresses the rate at which the gross national product (GNP) increases from one year to the next.

- **GNP:** The total output of an economy. Total final value of goods and services produced in a national economy over a period, usually one year plus net income from abroad and without any depreciation. The GNP growth rate is the primary indicator of the economic status.

- **GDP:** This is a comprehensive measure of the economic activity that takes place in a country during a certain period. It is the total value in terms of money at market prices of all goods and services produced within the country generally in a year, excluding net income receive from abroad.

- **Inflation:** It refers to an economic situation when the prices of various commodities are looking up or raising and there is a loss of purchasing power. This situation results in falling of real value of money as a certain amount of money can buy fewer goods.

- **Deflation:** Deliberate attempts may be made by the government to bring down the domestic prices and income by adopting a policy of deflation. The policy of deflation may take the shape of raising the interest rate structure in the country through increasing the bank rate.

- **Devaluation:** It refers to a reduction by the government in the country's official rate of exchange between its own currency and other currencies.

- **Depreciation:** It refers to the reduction in the external value due to market forces.

- **Revaluation:** It refers to an increase by the government of the country in the value of its currency in terms of other currency. This is done by increasing the par value of the currency in terms of gold.