

# Porter's Five Forces

## Competitive Strategy, Lecture 2

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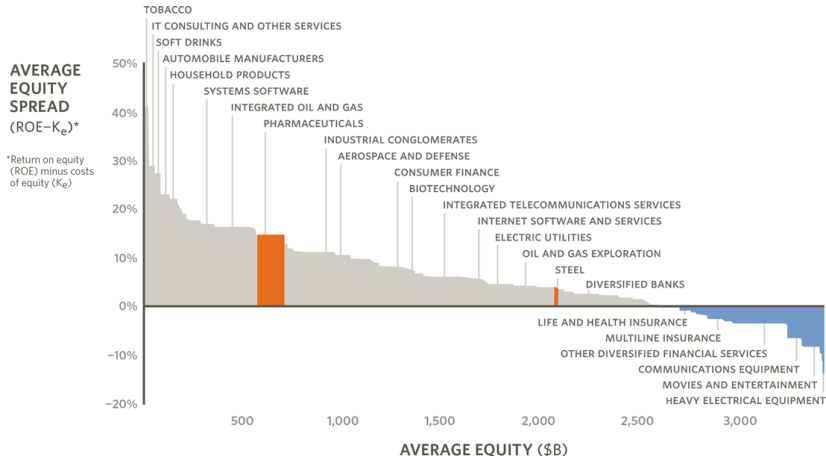
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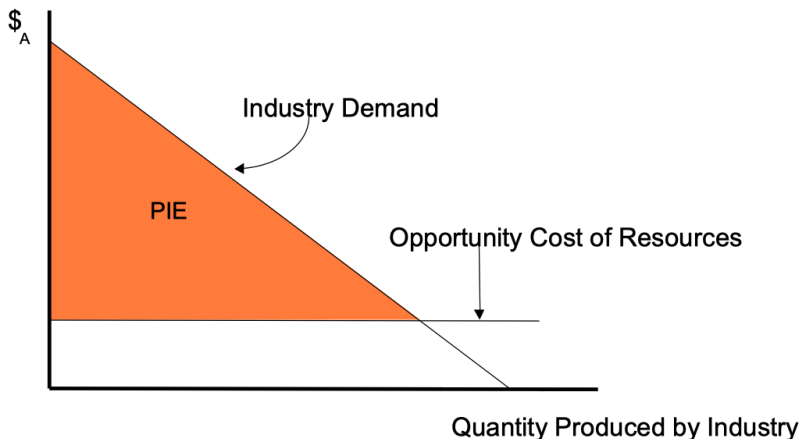
# Overview of Today

- Industry Profits
- Five Forces Framework
- Notes and Caveats
- The Big Picture of CS

# Longrun Profitability (Ghemawat & Rivkin, 2014)

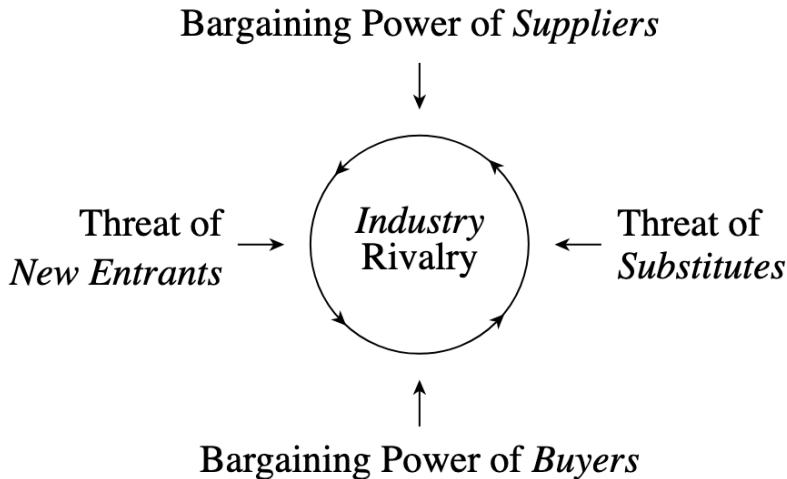


# Pi(e) Economics



- Demand  $\sim f(\text{Marketing})$ , Cost  $\sim f(\text{Operations})$

# Porter's Five Forces Framework



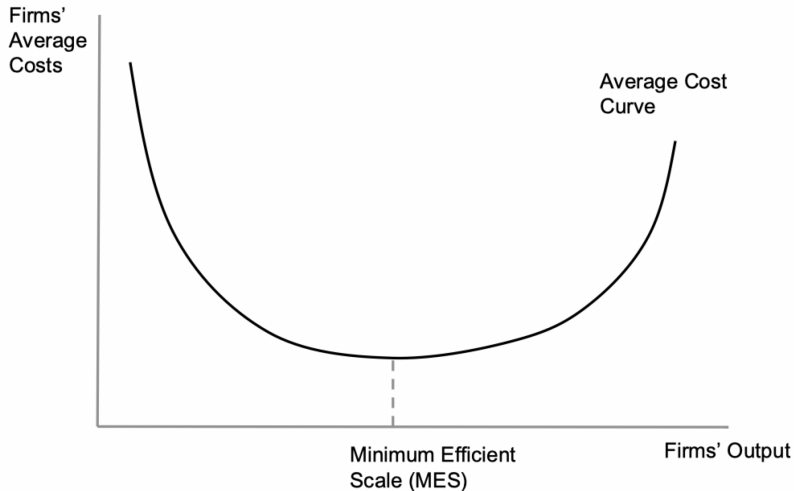
# Threat of Substitutes

- New product or service meets the same needs in a different way
- Examples
  - Zoom vs travel
  - Email vs snailmail
- Extended example: Airlines
  - Short travel – cars, buses, trains
  - Long travel?

# Threat of Entrants

- Real constraints: laws of nature
  - Scale economies
  - Learning-by-doing
  - Brand equity
  - Relationships
  - Network effects
- Artificial constraints: imposed by society
  - Real property rights, e.g. mines
  - Production/use rights, e.g. e.g. patents
  - Licensing: liquor, taxi medallions, CPAs
  - Contractual, e.g. exclusive and/or existing long-term

# Economies of Scale





# Learning-by-Doing

- Costs fall with accumulated production
- Example: Search engines
  - Search engine market shares in October 2015 Google: 64% Bing: 34%
  - Bing launched in 2009, not profitable until October 2015 Losses of \$1 billion/quarter in 2011!
  - More market share = more searches = better results in future

# Branding

- Value (of product) rises with accumulated marketing efforts
- Less mechanical and more cognitive/psychological than LBD
- Certainly no less important

# Note 1: Market Definition

- FFF leaves open first order questions
  - Measure internal rivalry?
  - Draw the line between “rivals” and “extended rivals”?
  - Measure “extended rivalry”?
  - How far to extend?
- Example: Luxury car v. SUV?

## Note 2A: Costs Include Opportunity Costs

$$Price \sim \frac{Profits}{Risk}$$

	On-Campus	Enhanced Off-Campus
Tuition	\$57,642	\$57,642
Student Life Fee	\$1,656	\$1,656
Room & Meals	\$17,004	\$17,004*

## Note 2B: Costs Include Opportunity Costs

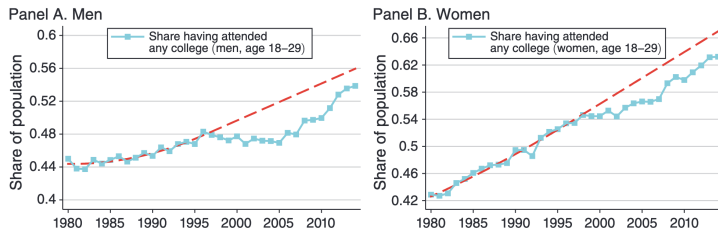


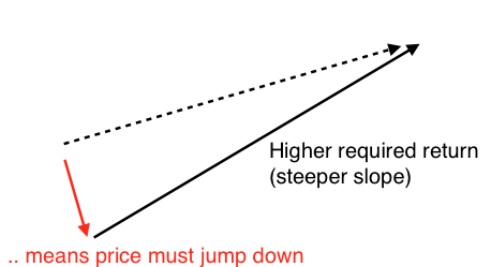
FIGURE 1. FRACTION TO HAVE EVER ATTENDED COLLEGE AMONG PERSONS AGED 18–29, 1980–2013

*Notes:* This figure reports trends in the share of men and women (age 18–29) who have attended at least one year of college. This series is constructed from the Current Population Survey (CPS) using CPS survey weights. The dashed line is the predicted college attendance rates based on a quadratic trend that is fit to the 1980–1996 period.

## Note 3: Book Returns Are Not Market Returns

$$\text{Price} \sim \frac{\text{Profits}}{\text{Risk}}$$

Value



# What Else is Missing with 5F?

- Strategic Interaction
- Competitive Advantage
- Innovation
- Dynamics
- Risk

# History of Economic Thought

- CS follows IO at about a decade lag
  - IO 70s: Structure-Conduct-Performance (Part 1)
  - IO 80s: Game Theory (Part 2)
  - IO 90s: Organizational Economics (Part 3)
  - IO 00s: New Empirical IO (Grad School)
  - IO 10s: Empirical Dynamics (Grad School)



# Next Week: Value Creation and Capture

- This week: How big is the pie?
- Next week: How big is your slice?
- From Industry to Firm
  - Or, from Between-Industry to Within-Industry
- Huge differences in firm profitability within-industry
  - So what makes a firm capture value?