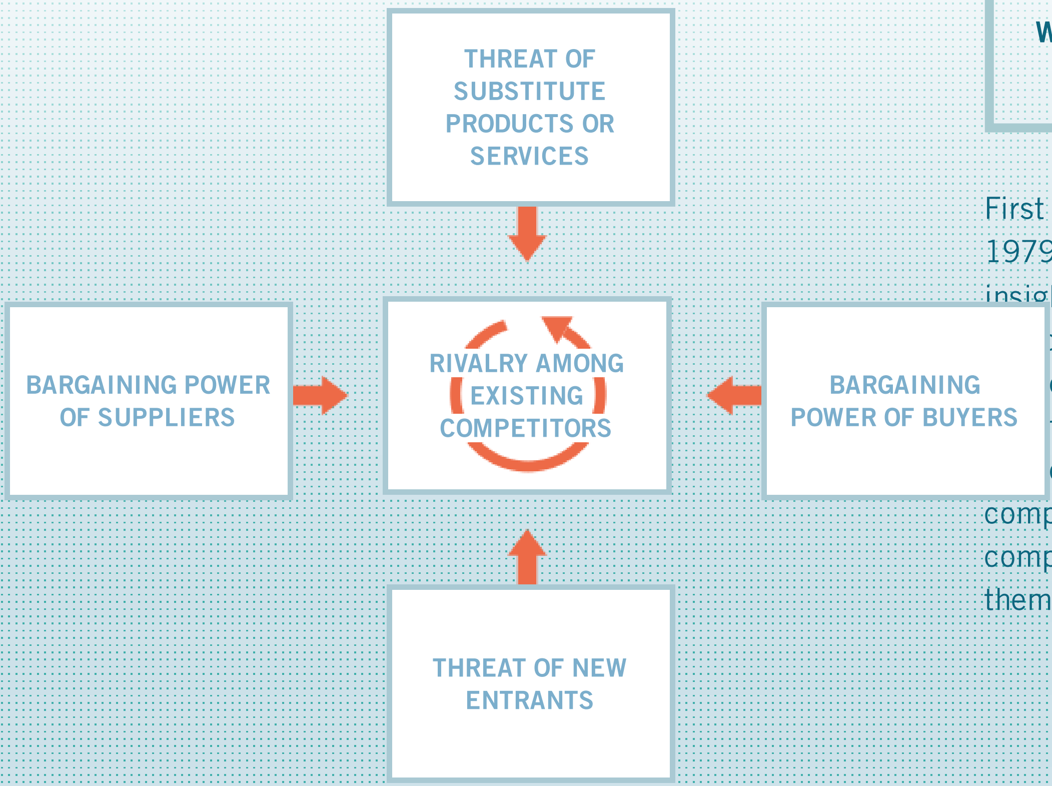
The Five Forces

THE FIVE FORCES IS A FRAMEWORK FOR UNDERSTANDING THE COMPETITIVE FORCES AT WORK IN AN INDUSTRY, AND WHICH DRIVE THE WAY ECONOMIC VALUE IS DIVIDED AMONG INDUSTRY ACTORS.



First described by Michael Porter in his classic 1979 *Harvard Business Review* article, Porter's insights started a revolution in the strategy field continue to shape business practice and emic thinking today. A Five Forces analysis help companies assess industry ctiveness, how trends will affect industry competition, which industries a company should compete in—and how companies can position themselves for success.

Key Industry Structure Concepts

Every industry is different, but the underlying drivers of profitably are the same in every industry.

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The Five Forces determine the competitive structure of an industry, and its profitability. Industry structure, together with a company's relative position within the industry, are the two basic drivers of company profitability.

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Analyzing the Five Forces can help companies anticipate shifts in competition, shape how industry structure evolves, and find better strategic positions within the industry.

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How the Five Forces Work

IN THEORY

Bargaining Power of Buyers

1

Powerful customers can use their clout to force prices down or demand more service at existing prices, thus capturing more value for themselves. Buyer power is highest when buyers are large relative to the competitors serving them, products are undifferentiated and represent a significant cost for the buyer, and there are few switching costs to shifting business from one competitor to another. They can play rivals against each other—especially if an industry's products are undifferentiated, it's inexpensive to switch loyalties, and price trumps quality.

There may be multiple buyer segments in a given industry

IN PRACTICE: THE AIRLINE INDUSTRY

Bargaining Power of Buyers — HIGH

Despite the fragmentation of buyers, airlines have a hard time differentiating themselves and creating customer loyalty, switching costs for buyers are nearly non-existent, and the proliferation of budget airlines undermines price levels.

with different levels of power.

2 Bargaining Power of Suppliers

Companies in every industry purchase various inputs from suppliers, which account for differing proportions of cost. Powerful suppliers can use their negotiating leverage to charge higher prices or demand more favorable terms from industry competitors, which lowers industry profitability. If there are only one or two suppliers of an essential input product, for example, or if switching suppliers is expensive or time consuming, a supplier group wields more power.

Bargaining Power of Suppliers — HIGH

The major supplier groups to the airline industry are aircraft, engines, airports, and fuel suppliers. Each of the major supplier groups are highly concentrated and has huge clout. Airlines often face high cost of switching suppliers because of the benefits of fleet compatibility and the necessity of utilizing major airports.

3 Threat of New Entrants

The threat of new entrants into an industry can force current players to keep prices down and spend more to retain customers. Actually, entry brings new capacity and pressure on prices and costs. The threat of entry, therefore, puts a cap on the profit potential of an industry. This threat depends on the size of a series of barriers to entry, including economies of scale, to the cost of building brand awareness, to accessing distribution channels, to government restrictions.

The threat of entry also depends on the capabilities of the likely potential entrants. If there are well established companies in the industry operating in other geographic regions, for example, the threat of entry rises.

Threat of New Entrants — HIGH

The airline industry continues to grow. The cost of entry is low with ready access to aircraft and financing, availability of skilled personnel, and access to gates. A steady stream of new airlines has entered the industry over the last several decades. New airlines often have advantages due to less seniority of personnel, which lowers wages, and newer aircraft with greater fuel efficiency.

4 Threat of Substitute Products or Services

When a new product or service meets the same basic need in a different way, industry profitability suffers. Videoconferencing is a substitute for travel. Email is a substitute for express mail.

The threat of a substitute is high if it offers an attractive price-performance trade-off relative to the industry's product or if the buyer's cost of switching to the substitute is low.

Threat of Substitute Products or Services — LOW

There is no effective substitute for air travel, especially for longer distances. For short haul travel, substitutes include automobile, bus or rail travel.

5 Rivalry Among Existing Competitors

If rivalry is intense, it drives down prices or dissipates profits by raising the cost of competing. Companies compete away the value they create. Rivalry tends to be especially fierce if:

- *Competitors are numerous or are roughly equal in size and market position*

Rivalry Among Existing Competitors — HIGH

There are numerous airlines who compete for every route. Since differentiation is low and fixed costs are high, there is constant pressure for price competition, and to match improvements in technology, cabin features, and customer service.

- *Industry growth is slow*
- *There are high fixed costs, which create incentives for price cutting*
- *Exit barriers are high*
- *Rivals are highly committed to the business*
- *Firms have differing goals, diverse approaches to competing, or lack familiarity with one another*

> READ FULL ANALYSIS ON INTERNATIONAL AIR TRANSPORT ASSOCIATION VISION 2050

INDUSTRY STRUCTURE IS DYNAMIC

Industry structure changes over time, and is not static. Over time, buyers or suppliers can become more or less powerful. Technological or managerial innovations can make new entry or substitution more or less likely. Changes in regulation can change the intensity of rivalry, or affect barriers to entry. Choices by competition, such as new pricing or distribution approaches, can also affect the path of industry competition.

Five Forces analysis is essential to anticipate and exploit industry structural change.

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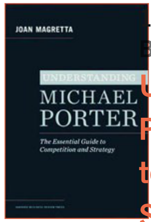
by Michael E. Porter



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