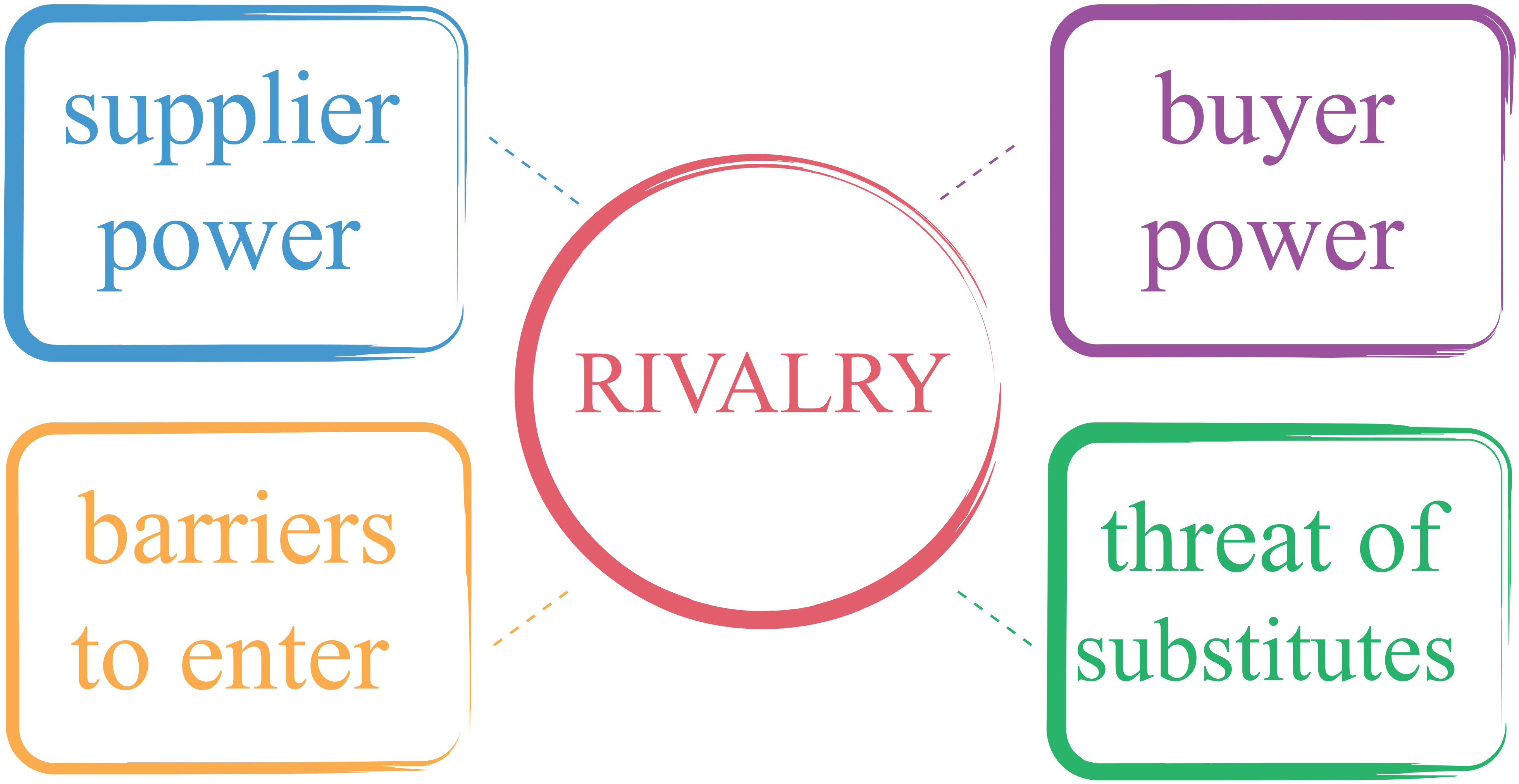
Porter's Five Forces

Ovidijus Jurevicius | May 27, 2013 Print

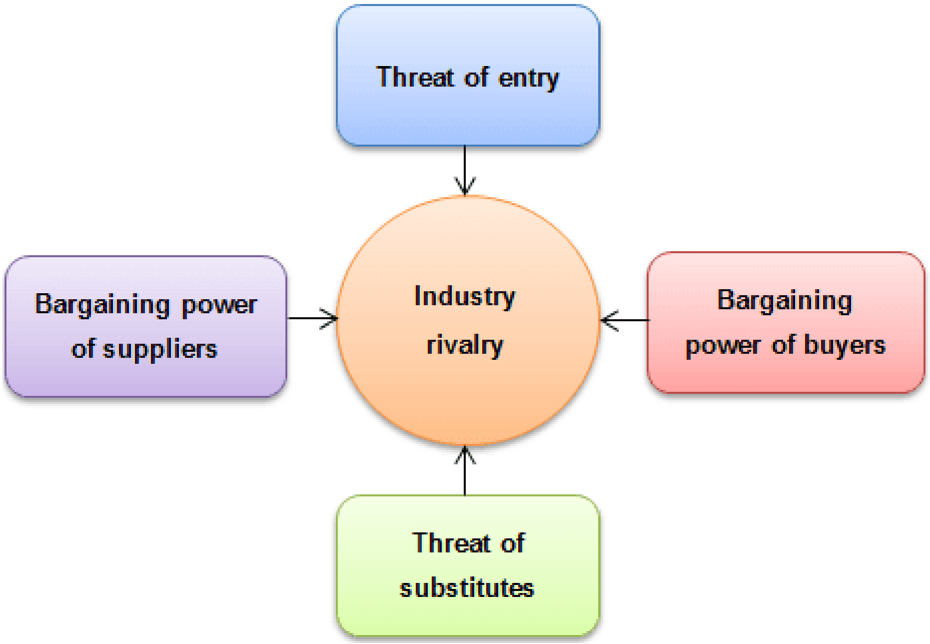

supplier power
buyer power
RIVALRY
barriers to enter
threat of substitutes

Definition

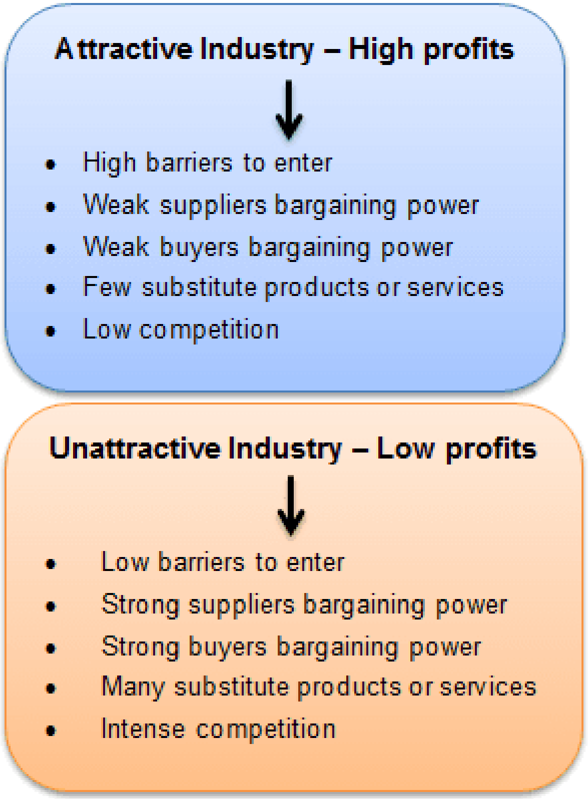
Porter's five forces model is an analysis tool that uses five industry forces to determine the intensity of competition in an industry and its profitability level.[1]

Understanding the tool

Five forces model was created by M. Porter in 1979 to understand how five key competitive forces are affecting an industry. The five forces identified are:



These forces determine an industry structure and the level of competition in that industry. The stronger competitive forces in the industry are the less profitable it is. An industry with low barriers to enter, having few buyers and suppliers but many substitute products and competitors will be seen as very competitive and thus, not so attractive due to its low profitability.



It is every strategist's job to evaluate company's competitive position in the industry and to identify what strengths or weakness can be exploited to strengthen that position. The tool is very useful in formulating firm's strategy as it reveals how powerful each of the five key forces is in a particular industry.

Threat of new entrants. This force determines how easy (or not) it is to enter a particular industry. If an industry is profitable and there are few barriers to enter, rivalry soon intensifies. When more organizations compete for the same market share, profits start to fall. It is essential for existing organizations to create high barriers to enter to deter new entrants. Threat of new entrants is high when:

- Low amount of capital is required to enter a market;
- Existing companies can do little to retaliate;

- Existing firms do not possess patents, trademarks or do not have established brand reputation;
- There is no government regulation;
- Customer switching costs are low (it doesn't cost a lot of money for a firm to switch to other industries);
- There is low customer loyalty;
- Products are nearly identical;
- Economies of scale can be easily achieved.

Bargaining power of suppliers. Strong bargaining power allows suppliers to sell higher priced or low quality raw materials to their buyers. This directly affects the buying firms' profits because it has to pay more for materials. Suppliers have strong bargaining power when:

- There are few suppliers but many buyers;
- Suppliers are large and threaten to forward integrate;
- Few substitute raw materials exist;
- Suppliers hold scarce resources;
- Cost of switching raw materials is especially high.

Bargaining power of buyers. Buyers have the power to demand lower price or higher product quality from industry producers when their bargaining power is strong. Lower price means lower revenues for the producer, while higher quality products usually raise production costs. Both scenarios result in lower profits for producers. Buyers exert strong bargaining power when:

- Buying in large quantities or control many access points to the final customer;
- Only few buyers exist;
- Switching costs to other supplier are low;
- They threaten to backward integrate;
- There are many substitutes;
- Buyers are price sensitive.

Threat of substitutes. This force is especially threatening when buyers can easily find substitute products with attractive prices or better quality and when buyers can switch from one product or service to another with little cost. For example, to switch from coffee to tea doesn’t cost anything, unlike switching from car to bicycle.

Rivalry among existing competitors. This force is the major determinant on how competitive and profitable an industry is. In competitive industry, firms have to compete aggressively for a market share, which results in low profits. Rivalry among competitors is intense when:

- There are many competitors;
- Exit barriers are high;
- Industry of growth is slow or negative;
- Products are not differentiated and can be easily substituted;
- Competitors are of equal size;
- Low customer loyalty.

Although, Porter originally introduced five forces affecting an industry, scholars have suggested including the sixth force: **complements**. Complements increase the demand of the primary product with which they are used, thus, increasing firm’s and industry’s profit potential. For example, iTunes was created to complement iPod and added value for both products. As a result, both iTunes and iPod sales increased, increasing Apple’s profits.

Using the tool

We now understand that Porter’s five forces framework is used to analyze industry’s competitive forces and to shape organization’s strategy according to the results of the analysis. But how to use this tool? We have identified the following steps:

- Step 1. Gather the information on each of the five forces
- Step 2. Analyze the results and display them on a diagram
- Step 3. Formulate strategies based on the conclusions

Step 1. Gather the information on each of the five forces. What managers should do during this step is to gather information about their industry and to check it against each of the factors (such as "number of competitors in the industry") influencing the force. We have already identified the most important factors in the table below.

Porter's Five Forces Factors
Threat of new entry
• Amount of capital required • Retaliation by existing companies • Legal barriers (patents, copyrights, etc.) • Brand reputation • Product differentiation • Access to suppliers and distributors • Economies of scale • Sunk costs • Government regulation
Supplier power
• Number of suppliers • Suppliers' size • Ability to find substitute materials • Materials scarcity • Cost of switching to alternative materials • Threat of integrating forward

Buyer power
• Number of buyers • Size of buyers • Size of each order • Buyers’ cost of switching suppliers • There are many substitutes • Price sensitivity • Threat of integrating backward
Threat of substitutes
• Number of substitutes • Performance of substitutes • Cost of changing
Rivalry among existing competitors
• Number of competitors • Cost of leaving an industry • Industry growth rate and size • Product differentiation • Competitors’ size • Customer loyalty • Threat of horizontal integration • Level of advertising expense

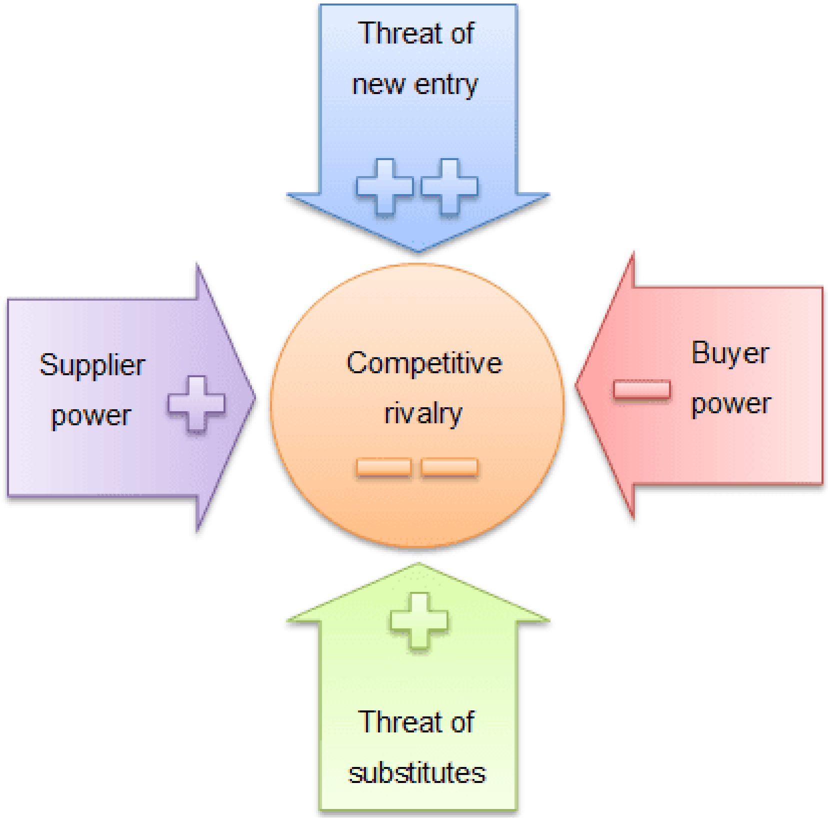
Step 2. Analyze the results and display them on a diagram. After gathering all the information, you should analyze it and determine how each force is affecting an industry. For example, if there are many companies of equal size operating in the slow growth industry, it means that rivalry between existing companies is strong. Remember that five forces affect different industries differently so don't use the same results of analysis for even similar industries!

Step 3. Formulate strategies based on the conclusions. At this stage, managers should formulate firm's strategies using the results of the analysis For example, if it is hard to achieve economies of scale in the market, the company should pursue cost leadership strategy. Product development strategy should be used if the current market growth is slow and the market is saturated.

Although, Porter's five forces is a great tool to analyze industry's structure and use the results to formulate firm's strategy, it has its limitations and requires further analysis to be done, such as SWOT, PEST or Value Chain analysis.

Example

This is Porter's five forces analysis example for an automotive industry.



Porter's Five Forces Evaluation

Threat of new entry (very weak)

- Large amount of capital required
- High retaliation possible from existing companies, if new entrants would bring innovative products and ideas to the industry
- Few legal barriers protect existing companies from new entrants
- All automotive companies have established brand image and reputation

- Products are mainly differentiated by design and engineering quality
- New entrant could easily access suppliers and distributors
- A firm has to produce at least 5 million (by some estimations) vehicles to be cost competitive, therefore it is very hard to achieve economies of scale
- Governments often protect their home markets by introducing high import taxes

Supplier power (weak)

- Large number of suppliers
- Some suppliers are large but the most of them are pretty small
- Companies use another type of material (use one metal instead of another) but only to some extent (plastic instead of metal)
- Materials widely accessible
- Suppliers do not pose any threat of forward integration

Buyer power (strong)

- There are many buyers
- Most of the buyers are individuals that buy one car, but corporates or governments usually buy large fleets and can bargain for lower prices
- It doesn't cost much for buyers to switch to another brand of vehicle or to start using other type of transportation
- Buyers can easily choose alternative car brand
- Buyers are price sensitive and their decision is often based on how much does a vehicle cost
- Buyers do not threaten backward integration

Threat of substitutes (weak)

- There are many alternative types of transportation, such as bicycles, motorcycles, trains, buses or planes
- Substitutes can rarely offer the same convenience

- Alternative types of transportation almost always cost less and sometimes are more environment friendly

Competitive rivalry (very strong)
• Moderate number of competitors • If a firm would decide to leave an industry it would incur huge losses, so most of the time it either bankrupts or stays in automotive industry for the lifetime • Industry is very large but matured • Size of competing firm's vary but they usually compete for different consumer segments • Customers are loyal to their brands • There is moderate threat of being acquired by a competitor

Sources

1. Porter, M.E. (2008). The Five Competitive Forces That Shape Strategy. Harvard Business Review. Available at: http://hbr.org/2008/01/the-five-competitive-forces-that-shape-strategy/
2. Wikipedia (2013). Porter's Five Forces. Available at: http://en.wikipedia.org/wiki/Porter_five_forces_analysis

❮ Previous Topic
PEST & PESTEL Analysis

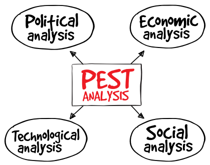
Next Topic ❯
IFE & EFE Matrices

Back to Tools

Related Articles

SWOT Analysis - How to do it properly!

Revealing organization's strong and weak points alongside opportunities and threats

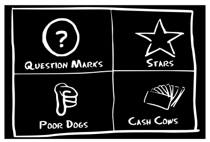


PEST & PESTEL Analysis

Knowing the external factors affecting your company

Competitive advantage

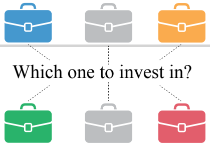
Standing out from the crowd



Boston Consulting Group (BCG) Matrix

Assessing and managing your business portfolio

GE McKinsey Matrix



Evaluating your business portfolio comprehensively

About Ovidijus Jurevicius

Ovidijus is the founder of SM Insight and the lead writer since 2013. His interest and studies in strategic management turned into SM Insight project, the No.1 source on the subject online.

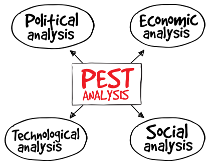
He's been using his knowledge on strategic management and swot analysis to analyze the businesses for the last 5 years. His work is published in many publications, including three books.

Popular topics

VRIO Analysis

Resource Based View

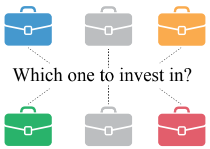
Value Chain Analysis



PEST & PESTEL Analysis

New topics

IFE & EFE Matrices



GE-McKinsey Matrix

Benchmarking

Competitive Profile Matrix

Join Our Newsletter

E-mail

Subscribe

Like Us

SM Insight

Like Page 5.6K likes

Navigate to

Contact