Introduction to Management

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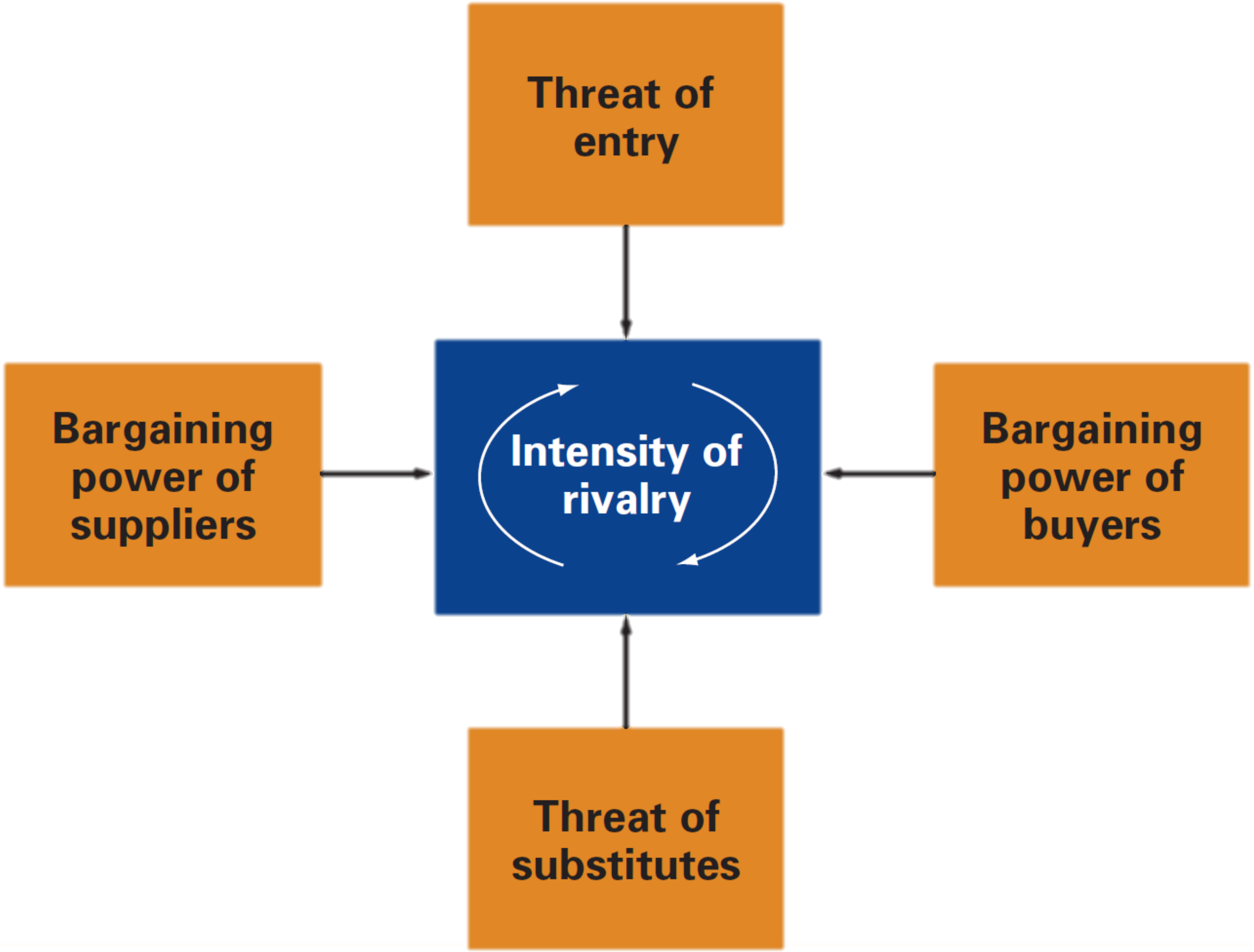
Porter’s five forces model

Porter's Competitive Forces Model

- the most popular frameworks for analyzing the task or industry environment is a model developed by Professor Michael Porter (1980);
- the ability of an organization to make a profit is influenced by **five competitive forces**: the *threat of entry by potential competitors, the power of buyers, the power of suppliers, the threat of substitute products, and the intensity of rivalry between firms already in the industry*
- A strong force thus constitutes a threat, whereas a weak force often gives managers the opportunity to increase sales, raise prices, and make higher profits.
- Despite the fact that the ''five forces'' framework focuses on business concerns rather than public policy, it also emphasizes extended competition for value rather than just competition among existing rivals, and the simpleness of its application inspired numerous companies as well as business schools to adopt its use (Wheelen and Hunger, 1998).

Porter’s five forces model



The intensity of rivalry

Rivalry among existing competitors takes many familiar forms, including price discounting, new product introductions, advertising campaigns, and service improvements. High rivalry limits the profitability of an industry.

The intensity of rivalry is greatest if:

1. **Competitors are numerous or are roughly equal in size and power.** Without an industry leader, practices desirable for the industry as a whole go unenforced.
2. ***Industry growth is slow.*** Slow growth precipitates fights for market share.
3. **Exit barriers are high.** Exit barriers, the flip side of entry barriers, arise because of such things as highly specialized assets or management's devotion to a particular business.
4. **Rivals are highly committed to the business and have aspirations for leadership.** Clashes of personality and ego have sometimes exaggerated rivalry to the detriment of profitability in fields such as the media and high technology.
5. **Firms cannot read each other's signals** well because of lack of familiarity with one another, diverse approaches to competing, or differing goals.

Factors that affect the intensity of rivalry

1. The nature of the product – a commodity product;
2. Demand and supply conditions;
3. Barriers to exit:
   a) the fixed costs of closing down capacity, such as the financial charges that must be taken to shut down a plant and lay off employees;
   b) an unwillingness to reduce capacity due to a belief, which may be misplaced, that demand will soon rebound and,
   c) government regulations,
4. Cost structure of firms;
5. The competitive structure of industry.
6. Complementary products and services.

The dimensionality of rivalry

- whether rivals converge to compete on the same dimensions, have a major influence on profitability.
- Rivalry is especially destructive to profitability if it gravitates solely to price because price competition transfers profits directly from an industry to its customers.
- **Price competition** is most liable to occur if:

1. Products or services of rivals are nearly identical and there are few switching costs for buyers.
2. Fixed costs are high and marginal costs are low.
3. Capacity must be expanded in large increments to be efficient.
4. The product is perishable. Perishability creates a strong temptation to cut prices and sell a product while it still has value.

- **Competition on dimensions other than price—on product features, support services, delivery time, or brand image, for instance—is less likely to erode profitability because it improves customer value and can support higher prices.**

threat of entry

- Managers often strive to reduce the threat of entry by pursuing strategies that raise barriers to entry.

Barriers to entry are the factors that make it costly for potential competitors to enter an industry and compete with firms already in the industry:

1. Economy of scale - cost reduction linked to the large output (Walmart & Lidl);
2. Brand loyalty - preference of consumers for the products of established companies (e.g. Coca-Cola & Pepsi, FedEx & UPS);
3. Demand-side benefits of scale-network effects where a buyer's willingness to pay for a company's product increases with the number of other buyers who also patronize the company;
4. Capital requirments;
5. Unequal access to distribution channels;
6. Restrictive government policy.

Bargaining power of buyers

- Ability of buyers **to bargain down prices** charged by firms in the industry or to raise the costs of firms in the industry by demanding better product quality and service;
- Powerful buyers should be viewed as a threat;
- Buyers are most powerful when one or more of the following conditions holds:

1. they are few that can purchase large quantities,
2. they can choose between equivalent products from many different firms, and
3. they can switch easily between the offerings of different firms (their switching costs are low),

(e.g. Walmart can demand to Procter & Gamble to lower prices in return for access to shelf space in store).

Bargaining power of buyers

Buyers are in a weak position when:

1. they are plentiful and purchase in small quantities,
2. they have little choice, and
3. they cannot switch easily between the offerings of different firms.

   (e.g. Microsoft's Windows and Apple operating system)

- **Switching costs** arise when it costs a buyer time, energy, and money to switch from a product offered by one enterprise to that offered by another;
- Managers often try to gain bargaining power over buyers by trying to increase the switching costs they must bear to adopt a rival product.

Bargaining power of suppliers

- Ability of suppliers to bargain up prices charged by firms in the industry or to raise the costs of firms in the industry by supplying lower-quality products and service.
- The analysis of supplier power typically focuses first on **the relative size and concentration of suppliers relative to industry participants** and
- second on **the degree of differentiation in the inputs supplied.** The ability to charge customers different prices in line with differences in the value created for each of those buyers usually indicates that the market is characterized by high supplier power and at the same time by low buyer power (Porter, 1989, 1996);
- <u>Threat</u>- where there is <u>only a single supplier</u> of an important input, that supplier has substantial bargaining power over the firm and can use this power to raise input prices and increase costs;
- <u>Opportunity</u>- when **buyers have bargaining power over them** and can reduce the prices they pay for inputs.

Bargaining power of suppliers

The bargaining power of an enterprise over its suppliers is greater if one or more of the following conditions holds:

1. the firm purchases in large quantities,
2. it can choose between multiple suppliers,
3. the costs of switching between suppliers is low, and
4. the firm is not dependent on any single supplier for important inputs.

The threat of substitutes

- **Substitute products** : the goods or services of different businesses or industries that can satisfy similar customer needs (e.g. coffe, tea, cola)
- If an industry’s products have few close substitutes, so that substitutes are a weak competitive force, then other things being equal, firms in the industry have <u>the opportunity to raise prices</u> and earn additional profits (e.g. Intel & AMD)
- The <u>threat of substitution</u> is also affected by switching costs – that is, the costs in areas such as retraining, retooling and redesigning that are incurred when a customer switches to a different type of product or service. The substitution process follows an S-shape curve. It starts slowly as a few trendsetters risk experimenting with the substitute, picks up steam if other customers follow suit, and finally levels off when nearly all the economical substitution possibilities have been exhausted.

Demand (supply) ~ Barriers to exit (entry)

	High barriers to entry	Low barriers to entry
Excess demand	Excess demand will persist Significant opportunity	Excess demand will not persist Transitory opportunity

	High barriers to exit	Low barriers to exit
Excess supply (capacity)	Excess capacity will persist Significant threat	Excess capacity will not persist Transitory threat

Fixed costs and competitive structure

- Fixed costs that require significant capital investments
- Fixed costs are high and marginal costs are low =>*This creates intense pressure for competitors to cut prices below their average costs, even close to their marginal costs, to steal market share while still making some contribution to covering fixed costs (Porter, 2008).*
- High fixed costs should be viewed as a threat, particularly when combined with weak demand conditions or excess capacity.
- One strategy involves trying to push off high fixed costs onto another organization-outsourcing.

Fixed costs and competitive structure

The **competitive structure** of an industry is the number and size distribution of required firms- relatively stable.

Relatively stable

Fragmented industry consists of many small or medium-sized companies, none of which is in a position to determine industry price.

Low entry barriers and commodity products

A **consolidated industry** is dominated by a few large companies (an oligopoly) or in extreme cases by just one company (a monopoly); here companies often are in a position to determine industry prices.

Firms are interdependent, actions of one firm affect directly its rivals

Complementary products and services

- **Complementors** are firms that provide goods or services that are *complementary* to the product produced by enterprises in the industry.

- Complements arise when the customer benefit of two products combined is greater than the sum of each product's value in isolation (e.g. hardware and software)

"Awareness of the five forces can help a company understand the structure of its industry and stake out a position that is more profitable and less vulnerable to attack." (Porter, 2008)

Porter's five forces model-synthesis

RIVALRY AMONG EXISTING COMPETITORS:
- Number of competitors
- Diversity of competitors
- Industry concentration
- Industry growth
- Quality differences
- Brand loyalty
- Barriers to exit
- Switching costs

THREAT OF NEW ENTRANTS

THREAT OF NEW ENTRANTS:
- Barriers to entry
- Economies of scale
- Brand loyalty
- Capital requirements
- Cumulative experience
- Government policies
- Access to distribution channels
- Switching costs

BARGAINING POWER OF SUPPLIERS

RIVALRY AMONG EXISTING COMPETITORS

BARGAINING POWER OF BUYERS

BARGAINING POWER OF SUPPLIERS:
- Number and size of suppliers
- Uniqueness of each supplier's product
- Focal company's ability to substitute

BARGAINING POWER OF BUYERS:
- Number of customers
- Size of each customer order
- Differences between competitors
- Price sensitivity
- Buyer's ability to substitute
- Buyer's information availability
- Switching costs

THREAT OF SUBSTITUTE PRODUCTS:
- Number of substitute products available
- Buyer propensity to substitute
- Relative price performance of substitute
- Perceived level of product differentiation
- Switching costs

THREAT OF SUBSTITUTE PRODUCTS

Threat of new entrants	Bargaining power of suppliers	Bargaining power of buyers	Threat of substitute products or services	Rivalry among existing competitors
- Barriers to entry - Economies of scale - Brand loyalty - Capital requirements - Cumulative experience - Government policies - Access to distribution channels - Switching costs	- Number of suppliers - Size of suppliers - Uniqueness of each supplier’s product or service - Focal company’s ability to substitute - Switching costs	- Number of customers - Size of each customer order - Differences between competitors - Price sensitivity - Buyer’s ability to substitute - Buyer’s information availability - Switching costs	- Number of substitute products available - Buyer propensity to substitute - Relative price performance of substitute - Perceived level of product differentiation - Switching costs	- Number of competitors - Diversity of competitors - Industry concentration - Industry growth - Quality differences - Brand loyalty - Barriers to exit - Switching costs