Porter's 5 Forces Definition

What Are Porter's Five Forces?

Porter's Five Forces is a model that identifies and analyzes five competitive forces that shape every industry and helps determine an industry's weaknesses and strengths. Five Forces analysis is frequently used to identify an industry's structure to determine corporate strategy. Porter's model can be applied to any segment of the economy to understand the level of competition within the industry and enhance a company's long-term profitability. The Five Forces model is named after Harvard Business School professor, Michael E. Porter.

Understanding Porter's Five Forces

Porter's Five Forces is a business analysis model that helps to explain why various industries are able to sustain different levels of profitability. The model was published in Michael E. Porter's book, "Competitive Strategy: Techniques for Analyzing Industries and Competitors" in 1980. The Five Forces model is widely used to analyze the industry structure of a company as well as its corporate strategy. Porter identified five undeniable forces that play a part in shaping every market and industry in the world, with some caveats. The five forces are frequently used to measure competition intensity, attractiveness, and profitability of an industry or market.

Porter's five forces are:

1. Competition in the industry

2. Potential of new entrants into the industry

3. Power of suppliers

4. Power of customers

5. Threat of substitute products

Key Takeaways

- Porter's Five Forces is a framework for analyzing a company's competitive environment.
- The number and power of a company's competitive rivals, potential new market entrants, suppliers, customers, and substitute products influence a company's profitability.
- Five Forces analysis can be used to guide business strategy to increase competitive advantage.

Competition in the Industry

The first of the five forces refers to the number of competitors and their ability to undercut a company. The larger the number of competitors, along with the number of equivalent products and services they offer, the lesser the power of a company. Suppliers and buyers seek out a company's competition if they are able to offer a better deal or lower prices. Conversely, when competitive rivalry is low, a company has greater power to charge higher prices and set the terms of deals to achieve higher sales and profits.

Potential of New Entrants Into an Industry

A company's power is also affected by the force of new entrants into its market. The less time and money it costs for a competitor to enter a company's market and be an effective competitor, the more an established company's position could be significantly weakened. An industry with strong barriers to entry is ideal for existing companies within that industry since the company would be able to charge higher prices and negotiate better terms.

Power of Suppliers

The next factor in the five forces model addresses how easily suppliers can drive up the cost of inputs. It is affected by the number of suppliers of key inputs of a good or service, how unique these inputs are, and how much it would cost a company to switch to another supplier. The fewer suppliers to an industry, the more a company would depend on a supplier. As a result, the supplier has more power and can drive up input costs and push for other advantages in trade. On the other hand, when there are many suppliers or low switching costs between rival suppliers, a company can keep its input costs lower and enhance its profits.

Power of Customers

The ability that customers have to drive prices lower or their level of power is one of the five forces. It is affected by how many buyers or customers a company has, how significant each customer is, and how much it would cost a company to find new customers or markets for its output. A smaller and more powerful client base means that each customer has more power to negotiate for lower prices and better deals. A company that has many, smaller, independent customers will have an easier time charging higher prices to increase profitability.

The Five Forces model can help businesses boost profits, but they must continuously monitor any changes in the five forces and adjust their business strategy.

Threat of Substitutes

The last of the five forces focuses on substitutes. Substitute goods or services that can be used in place of a company's products or services pose a threat. Companies that produce goods or services for which there are no close substitutes will have more power to increase prices and lock in favorable terms. When close substitutes are available, customers will have the option to forgo buying a company's product, and a company's power can be weakened.

Understanding Porter's Five Forces and how they apply to an industry, can enable a company to adjust its business strategy to better use its resources to generate higher earnings for its investors.