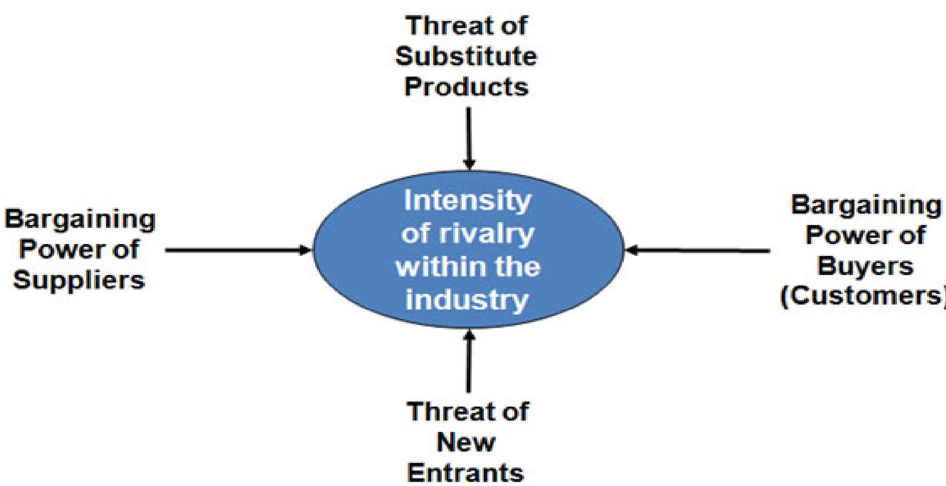
Porter's Five Forces Model: analysing industry structure

Overview of the Five Forces Model

Porter identified five factors that act together to determine the nature of competition within an industry. These are the:

- Threat of new entrants to a market
- Bargaining power of suppliers
- Bargaining power of customers ("buyers")
- Threat of substitute products
- Degree of competitive rivalry



He identified that high or low industry profits (e.g. soft drinks v airlines) are associated with the following characteristics:

High industry profits associated with:	**Low industry profits associated with:**
Weak suppliers	Strong suppliers
Weak customers (buyers)	Strong customers (buyers)
High entry barriers	Low entry barriers
Few opportunities for substitutes	Many opportunities for substitutes
Little rivalry	Intense rivalry

Let's look at each one of the five forces in a little more detail to explain how they work.

Threat of new entrants to an industry

- If new entrants move into an industry they will gain market share & rivalry will intensify
- The position of existing firms is stronger if there are **barriers** to entering the market
- If **barriers to entry** are low then the threat of new entrants will be high, and vice versa

Barriers to entry are, therefore, very important in determining the threat of new entrants. An industry can have one or more barriers. The following are common examples of successful barriers:

Barrier	Notes
Investment cost	High cost will deter entry High capital requirements might mean that only large businesses can compete
Economies of scale available to existing firms	Lower unit costs make it difficult for smaller newcomers to break into the market and compete effectively
Regulatory and legal restrictions	Each restriction can act as a barrier to entry E.g. patents provide the patent holder with protection, at least in the short run
Product differentiation (including branding)	Existing products with strong USPs and/or brand increase customer loyalty and make it difficult for newcomers to gain market share
Access to suppliers and distribution channels	A lack of access will make it difficult for newcomers to enter the market
Retaliation by established products	E.g. the threat of price war will act to discourage new entrants. But note that competition law outlaws actions like predatory pricing

What makes an industry easy or difficult to enter? The following table helps summarise the issues you should consider:

Easy to Enter	Difficult to Enter
Common technology Access to distribution channels Low capital requirements No need to have high capacity and output Absence of strong brands and customer loyalty	Patented or proprietary know-how Well-established brands Restricted distribution channels High capital requirements Need to achieve economies of scale for acceptable unit costs

Bargaining power of suppliers

If a firm's suppliers have bargaining power they will:

- Exercise that power
- Sell their products at a higher price
- Squeeze industry profits

If the supplier forces up the price paid for inputs, profits will be reduced. It follows that the more powerful the customer (buyer), the lower the price that can be achieved by buying from them. Suppliers find themselves in a powerful position when:

- There are only a few large suppliers
- The resource they supply is scarce
- The cost of switching to an alternative supplier is high
- The product is easy to distinguish and loyal customers are reluctant to switch
- The supplier can threaten to integrate vertically
- The customer is small and unimportant
- There are no or few substitute resources available

Just how much power the supplier has is determined by factors such as:

Factor	Note
Uniqueness of the input supplied	If the resource is essential to the buying firm and no close substitutes are available, suppliers are in a powerful position
Number and size of firms supplying the resources	A few large suppliers can exert more power over market prices that many smaller suppliers each with a small market share
Competition for the input from other industries	If there is great competition, the supplier will be in a stronger position
Cost of switching to alternative sources	A business may be "locked in" to using inputs from particular suppliers – e.g. if certain components or raw materials are designed into their production processes. To change the supplier may mean changing a significant part of production

Bargaining power of customers

Powerful customers are able to exert pressure to drive down prices, or increase the required quality for the same price, and therefore reduce profits in an industry.

A great example in the UK currently is the dominant grocery supermarkets which are able exert great power over supply firms.

Several factors determine the bargaining power of customers, including:

Factor	Note
Number of customers	The smaller the number of customers, the greater their power
Their size of their orders	The larger the volume, the greater the bargaining power of customers
Number of firms supplying the product	The smaller the number of alternative suppliers, the less opportunity customers have for shopping around
The threat of integrating backwards	If customers pose a threat of integrating backwards they will enjoy increased power
The cost of switching	Customers that are tied into using a supplier's products (e.g. key components) are less likely to switch because there would be costs involved

Customers tend to enjoy strong bargaining power when:

- There are only a few of them
- The customer purchases a significant proportion of output of an industry
- They possess a credible backward integration threat – that is they threaten to buy the producing firm or its rivals
- They can choose from a wide range of supply firms
- They find it easy and inexpensive to switch to alternative suppliers

Threat of substitute products

A substitute product can be regarded as something that meets the same need

Substitute products are produced in a different industry –but crucially satisfy the same customer need. If there are many credible substitutes to a firm's product, they will limit the price that can be charged and will reduce industry profits.

As an example, consider the many substitutes that consumers now have to buying a newspaper for their news:

The extent of the threat depends upon

- The extent to which the price and performance of the substitute can match the industry's product
- The willingness of customers to switch
- Customer loyalty and switching costs

If there is a threat from a rival product the firm will have to improve the performance of their products by reducing costs and therefore prices and by differentiation.

Degree of competitive rivalry

If there is intense rivalry in an industry, it will encourage businesses to engage in

- Price wars (competitive price reductions),
- Investment in innovation & new products
- Intensive promotion (sales promotion and higher spending on advertising)

All these activities are likely to increase costs and lower profits.
Several factors determine the degree of competitive rivalry; the main ones are:

Factor	Note
Number of competitors in the market	Competitive rivalry will be higher in an industry with many current and potential competitors
Market size and growth prospects	Competition is always most intense in stagnating markets
Product differentiation and brand loyalty	The greater the customer loyalty the less intense the competition The lower the degree of product differentiation the greater the intensity of price competition
The power of buyers and the availability of substitutes	If buyers are strong and/or if close substitutes are available, there will be more intense competitive rivalry
Capacity utilisation	The existence of spare capacity will increase the intensity of competition
The cost structure of the industry	Where fixed costs are a high percentage of costs then profits will be very dependent on volume As a result there will be intense competition over market shares
Exit barriers	If it is difficult or expensive to exit an industry, firms will remain thus adding to the intensity of competition