Michael Porter's Five forces

Porter's five forces model is a framework to analyze the attractiveness of the industry. This framework helps to develop understanding of the micro-environment. It evaluates the factors that affect the ability of the company to serve its customers and make profit. This framework helps an organization to perform better than the industry standard by their core competencies and better business model. If organization is able to utilize this framework successfully in their industry, they have better chance of making more profits than their competitors.

Porter's five forces include - three forces from 'horizontal' competition: *the threat of substitute products or services*, *the threat of established rivals*, and *the threat of new entrants*; and two forces from 'vertical' competition: *the bargaining power of suppliers* and *the bargaining power of customers*.

Lets try to understand each of these forces in more detail:

1. **Threat of new entrants**:

   Attractive industry attracts new entrants. If the entry and exit barriers are low than threat of new entrant plays a big role in the business strategy. If the profit margins are high, Government policies are highly encouraging, sinking cost is less, capital requirement is less and many such factors are in support of new entrants than more and more competition will come up. It becomes important for company to keep the differentiation from the competition; it can if in form product differentiation or service differentiation.

2. **Threat of product or service substitute:**

   If the switching cost of the buyer is less and there are similar substitute available in the market, it becomes important to retain the existing customers and capture more of them. To take an example, without phone number portability in India, chances of customer sticking to the same operators were high even if he didn't like the service. With new regulation and easy number portability option has created pressure on telecom operators to improve their services. To handle such situation, it is important to increase the switching cost of the customer, have product differentiation, have loyalty programs and put efforts to increase the market pie itself.

3. **Bargaining power of Customers:**

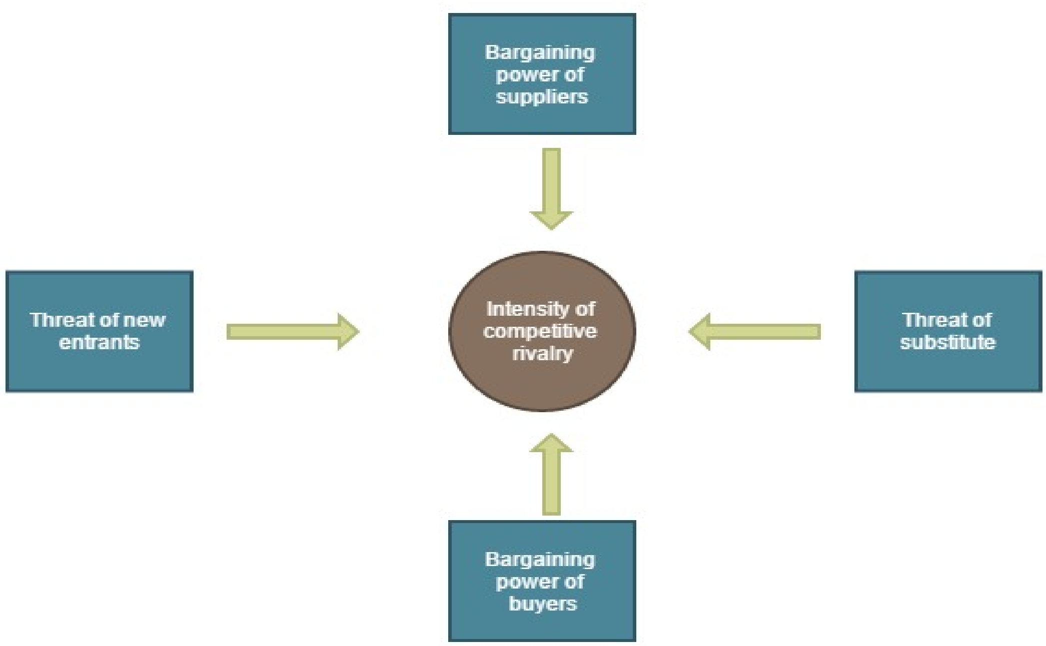
   If the customer's bargaining power increases the profitability is set to fall. Firm must take necessary steps to reduce the bargaining power of the customers. Bargaining power of the customers increase with increasing number of substitutes, higher switching cost of firm compare to customer, buyer's information availability, less differentiation from other products, overall performance of the industry and many others such factors. It is important to keep the competition in check, have differentiation in product, increasing the switching cost of the customer, have loyalty programs etc.

4. Bargaining power of supplier:

If the suppliers bargaining power increases then the cost of development is set to go up. Many firms may even find it difficult to operate if they have high dependency on few suppliers. Bargaining power of supplier increases if there are few suppliers, have quality differentiation, timeliness of the providing the raw material, distribution mode, their importance in the product development, number of substitute etc. It is important for firm to have multiple suppliers and have less dependency on them, always have back up substitute in case of failure.

5. Intensity of competitive rivalry

This force actually defines the competitiveness in the industry. With fierce competition it becomes important to keep innovating and make more marketing expense. For example, we have observed intense competition between coca cola and pepsi.



Porter's five forces framework

Usage of the framework:

It may be starting point to understand the performance of the company wrt. to industry. It may also help to indicate the problem area and further analysis may help to resolve the issue and make firm more profitable. According to Porter, the five forces model should be used at the line-of-business industry level; it is not designed to be used at the industry group or industry sector level. An industry is defined at a lower, more basic level: a market in which similar or closely related products and/or services are sold to buyers.

Factors Missing in the framework:

Porter’s five forces model is widely used framework, but it has certain limitations also. One factor missed in the framework was complementors, e.g. Intel processors and Microsoft’s windows. One complements the other. This framework was developed with assumptions that customer, suppliers and competitors are unrelated which is not true more often. To evaluate the various forces and impact is very important for making maximum utilization of this framework.