Porter's Five Forces Analysis

Coined by Michael Porter, a Professor of Strategy at Harvard Business School; he stated that a company's profitability in an industry is determined by five-industry level forces. They are:

Bargaining Power of Buyers: This broadly refers to the extent buyers are able to put pressure on the company, which is broadly a factor of the customer's ability to react to price changes. An industry with high bargaining power of buyers is one where buyers have the ability to choose from a variety of products offered by multiple companies. Their ability to choose leads to an increased bargaining power. In the modern economy, bargaining power of buyers is generally very high in industries where companies use pricing as the foremost tool to lure customers. An example of this is the Indian E-Commerce industry, where the top two players, Flipkart and Amazon, often use deep discounting to attract customers.

Bargaining Power of Suppliers: This broadly refers to the extent suppliers are able to put pressure on the company, when charging for the raw materials or products that they give to it. Suppliers usually sell raw materials to companies operating in the sectors like automotive, manufacturing, cement / construction, pharmaceuticals; while they usually give finished products to companies operating in sectors like banking/finance, media; where often a third-party software is a product that is used by them. This power is lower when there are many suppliers offering undifferentiated products and the power is substantially higher when there are fewer suppliers, who offer differentiated products. It is often determined by how much value addition does a supplier do in the raw material / finished product that is sold by them. From a company's perspective, the cost of switching from one supplier to another, for that particular raw material, determines the bargaining power of that supplier. In cases where the switching cost is low, the bargaining power of the supplier is low and in case the switching cost is high, the bargaining power of the supplier is higher. An industry with high bargaining power of suppliers is often characterized as one where companies face a lot of pressure on their profit margins due to increased pressure on price of raw materials.

Rivalry among Existing Competitors: As the factor suggests, an industry with high rivalry among existing competitors is one which is characterized by consistent price wars, high degrees of innovation, increased marketing attempts and service improvements. It is generally (not always) an industry, where the barriers to entry are low; which means minimum capital and legal requirements are required to set up a new business in that industry. Generally, an industry with high rivalry among existing competitors is also one where the bargaining power of buyers is high. This leads to the abovementioned characteristics of price wars, marketing, innovation et al. An example of this is the retail industry, where players like Avenue Supermarts Ltd., who owns and operates the 'D-Mart' chain of supermarkets in Western India, faces competition from other supermarkets like Aditya Birla Group's Food Bazaar, unorganized local supermarkets as well as online supermarkets like BigBasket, Zepto.

Threat of Substitutes Products: A substitute product nearly performs the same function as the industry's product and service but by different means. A company operating in an industry with high threat of substitute products suffers as they have to put a price ceiling to their offering. This, in turn affects an industry's profitability. Generally, an industry where the degree of differentiation in products is low is one where the threat of substitutes is higher. A low degree of product differentiation leaves a lot of scope for innovation, which leads to the creation of substitute products. An example of an industry where substitute products have had an impact on its performance is non-renewable energy industry (coal based power generation), where renewable energy companies (solar, wind energy) are having an impact on its performance.

Threat of New Entrants: As the factor indicates, it refers to an industry where the barriers to entry are low. An example of an industry where barriers to entry are low is e-commerce. Anyone can go online and use a Wix to create an online store, right? No, the sheer size of e-commerce players like Amazon and Flipkart, their logistical reach, warehousing systems and the subsequent market share that they have, is a big barrier to entry for a new player. This shows that a holistic industry analysis is required to comment on the easiness of setting up a new business in the industry and thereby comment on the threat of new entrants to existing players in the industry.