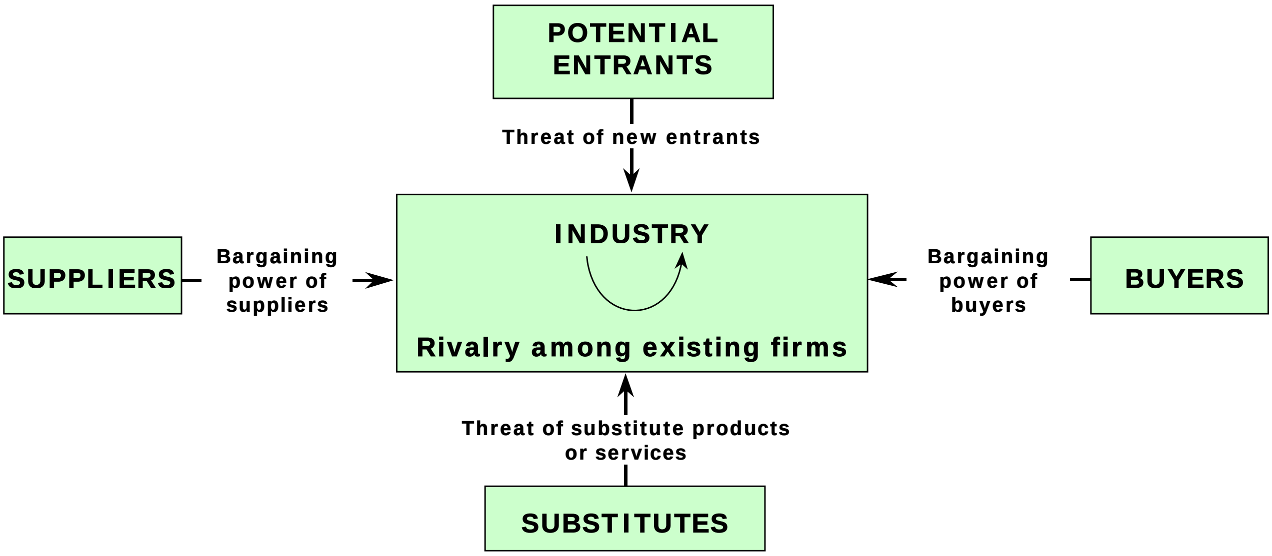
Porters Five Forces



Michael Porter's Five Forces model is a useful framework for analysing industry structure and profit potential. It highlights the need to look beyond size and growth in assessing industry attractiveness.

Each force is assessed qualitatively to identify whether it is likely to be strong and thus reduce the profitability of the industry, or weak and thus allow incumbents to earn high profits. For example, one type of supplier is labour. If the labour force is unionised it may have stronger power and thus reduce profitability of the industry.

Potential entrants, or barriers to entry can be a tricky force to analyse. Some people think that low barriers to entry is attractive – because it makes the business easier to enter. But, low barriers to entry also make the business less profitable – and so make it Unattractive.

Changes in technology, legislation, buyer behaviour etc can change the relative power of the Forces, making it more or less difficult for an industry (in the narrow sense) to make adequate returns.

Threat of new entrants

- Economies of scale
- Product differentiation
- Capital requirements
- Switching costs
- Access to distribution channels
- Cost disadvantages independent of scale, e.g.
  - Proprietary product technology
  - Favourable access to raw materials
  - Favourable locations
  - Government subsidies
  - Learning or experience curve

Bargaining power of suppliers

- It is dominated by a few companies and is more concentrated than the industry it sells to
- It is not obliged to compete with other substitute products for sales to the industry
- The industry is not an important customer of the supplier group
- The supplier's product is an important input to the buyer's business
- The supplier group's products are differentiated or it has built up switching costs
- The supplier group poses a credible threat of forward integration

Rivalry among existing firms

- Numerous or equally balanced competitor
- Slow industry growth
- High fixed or storage costs
- Lack of differentiation or switching costs
- Capacity augmented in large increments
- Diverse competitors
- High strategic stakes
- High exit barriers

Bargaining power of buyers

- It is concentrated or it purchases large volumes relative to seller sales.
- The products it purchases from the industry represent a significant fraction of the buyer's costs or purchases
- The products it purchases from the industry are standard or undifferentiated
- It faces few switching costs
- It earns low profits
- Buyers pose a credible threat of backward integration
- The industry's product is unimportant to the quality of the buyers' products or services
- The buyer has full information

Each Force can be analysed by considering a number of factors (shown in the example above). These factors combine to determine whether the force is positive (i.e., relatively low, resulting in a higher return than the average) or not. Judgement is required to estimate whether or not the overall impact is to increase average profitability above the average.

It is possible to use this framework to predict conditions under which the industry could become more profitable e.g. If a fragmented business consolidates, reducing rivalry.

It is also possible to use the framework to consider what a company can do to shape the industry to make it more attractive e.g., through consolidation.