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Porters Five Forces: content, application, critique

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The model of the Five Competitive Forces was developed by Michael E. Porter in his book „Competitive Advantage: Creating and Sustaining Superior Performance“ in 1980. Since than it has become an important tool for analyzing an organizations industry structure in strategic processes.

The Porters Five Forces model is actually one of the best-known tools for strategic planning. This reputation is at least partially due to the critique the model attracted over time.

Introduction

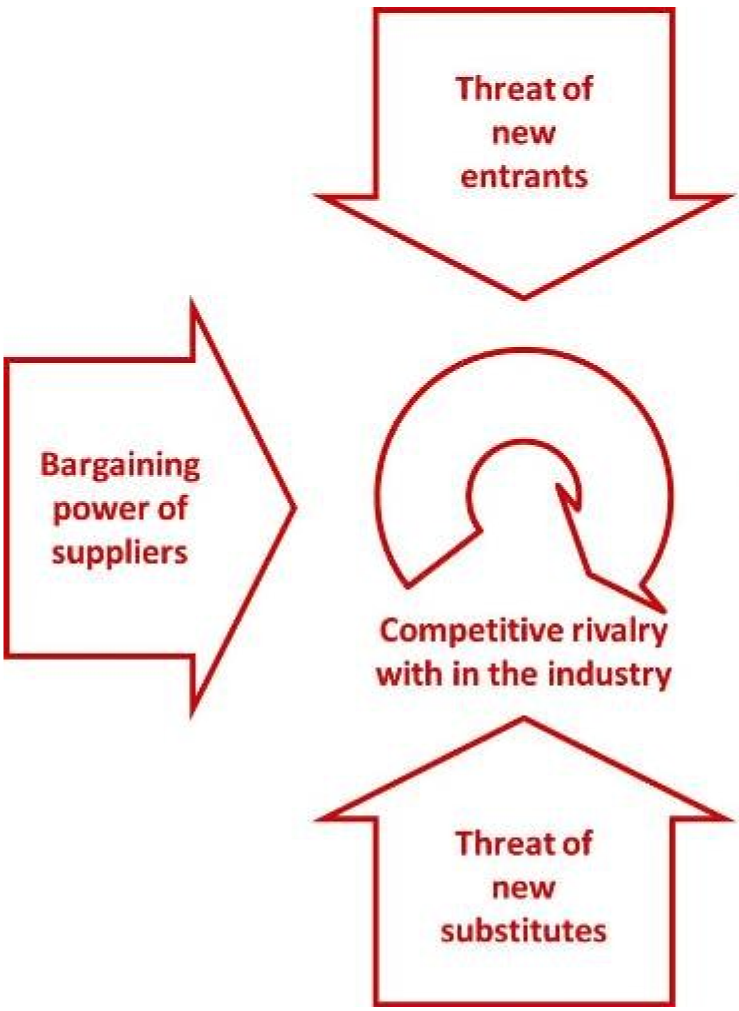
The Porters Five Forces model is based on the insight that a corporate strategy should meet the opportunities and threats in the organizations external environment. A competitive strategy should base on an understanding of industry structures and the way they change.

Porter has identified five competitive forces that shape every industry and every market. These forces determine the intensity of competition and hence the profitability and attractiveness of an industry.

A successful corporate strategy should modify these competitive forces in a way that improves the position of the organization. Porter's model supports the analysis of the driving forces in an industry. Based on the information derived from the Five Forces Analysis, management can decide how to influence or to exploit particular features of their industry.

The Five Competitive Forces

The Five Competitive Forces are typically described as follows:



The Porters Five Forces model

These five forces are based on microeconomics. They take into account supply and demand, complementary products and substitutes, the relationship between volume of production and cost of production, and market structures like monopoly, oligopoly or perfect competition:

Porters Five Forces	Areas of Microeconomics
Bargaining Power of Suppliers	Supply and demand theory, cost and production theory, price elasticity
Bargaining Power of Customers	Supply and demand theory, customer behavior, price elasticity
Rivalry between Existing Players	Market structures, number of players, market size and growth rates
Threat of Substitutes	Substitution effects
Threat of New Entrants	Market entry barriers
à Industry attractiveness	**à Profitability, supernormal profits**

Bargaining Power of Suppliers

The term ‘suppliers’ comprises all input sources that are needed in order to provide goods or services.

Supplier bargaining power is likely to be high when:

- The market is dominated by a few large suppliers rather than a fragmented source of supply,
- There are no substitutes for the particular input,
- The suppliers’ customers are fragmented, so their bargaining power is low,
- The switching costs from one supplier to another are high,
- There is the possibility that suppliers integrate forwards in order to obtain higher prices and margins. This threat is especially high

when

- The buying industry has a higher profitability than the supplying industry,
- Forward integration provides economies of scale for the supplier,
- The buying industry hinders the supplying industry in their development (e.g. reluctance to accept new releases of products),
- The buying industry has low barriers to entry.

In such situations, the buying industry often faces a high pressure on margins from their suppliers. The dependence powerful suppliers can potentially reduce strategic options for the organization.

Bargaining Power of Customers

Similarly, the bargaining power of customers determines how much pressure customers can impose on margins and volumes.

Customers bargaining power is likely to be high when

- They buy large volumes / there is a concentration of buyers,
- The supplying industry comprises a large number of small operators
- The supplying industry operates with high fixed costs,
- The product is undifferentiated and can be replaces by substitutes,
- Switching to an alternative product is relatively simple and is not related to high costs,
- Customers have low margins and are price-sensitive,
- Customers could produce the product themselves,

- The product is not of strategical importance for the customer,
- The customer knows about the production costs of the product
- There is the possibility for the customer to integrate backwards.

Threat of New Entrants

The easier it is for other companies to enter an industry, the higher will be the competition in that industry. In such a situation, new entrants could change major determinants of the market environment (e.g. market shares, prices, customer loyalty, service levels) at any time. There is always a latent pressure for reaction and adjustment for existing players in this industry.

The level of threat from new entrants depends on the extent to which there are barriers to entry. These are typically

- Economies of scale (minimum size requirements for profitable operations),
- High initial investments and fixed costs,
- Cost advantages of existing players due to experience curve effects of operation with fully depreciated assets,
- Brand loyalty of customers
- Protected intellectual property like patents, licenses etc,
- Scarcity of important resources, e.g. qualified expert staff
- Access to raw materials is controlled by existing players,
- Distribution channels are controlled by existing players,
- Existing players have close customer relations, e.g. from long-term service contracts,

- High switching costs for customers
- Legislation and government action

Threat of Substitutes

A threat from substitutes arises if there are alternative products with lower prices of better performance parameters for the same purpose. They could potentially attract a significant proportion of market volume and hence reduce the potential sales volume for existing players. This category also relates to complementary products.

Similarly to the threat of new entrants, the treat of substitutes is determined by factors like

- Brand loyalty of customers,
- Close customer relationships,
- Switching costs for customers,
- The relative price for performance of substitutes,
- Current trends in technology, customer preferences etc.

Competitive Rivalry between Existing Players

This force describes the intensity of competition between existing players (companies) in an industry. High competitive pressure leads to pressure on prices, margins, and hence, on profitability for every single company in the industry.

Competition between existing players is likely to be high when

- There are many players of about the same size,
- Players have similar strategies

- There is not much differentiation between players and their products, hence, there is much price competition
- Low market growth rates (growth of a particular company is possible only at the expense of a competitor),
- Barriers for exit are high (e.g. expensive and highly specialized equipment),
- Customers are price sensitive and / or have low switching costs.

How to use the Insights from a Five Forces Analysis

Porters Five Forces Analysis can provide valuable information for three aspects of corporate planning:

Static Analysis

A static analysis looks at an industry or market segment as it is at present. It aims to understand the current situation. An example of a static analysis is a comparison of the competitors' current strategies, strengths and weaknesses.

A static analysis does not look at potential future changes.

The Five Forces Analysis allows determining the attractiveness of an industry. It provides insights on profitability. Thus, it supports decisions about entry to or exit from and industry or a market segment. Moreover, the model can be used to compare the impact of competitive forces on the own organization with their impact on competitors. Competitors may have different options to react to changes in competitive forces from their different resources and competences. This may influence the structure of the whole industry.

Dynamic Analysis

A dynamic analysis looks at changes over time. Technically, an analysis of past changes is a dynamic analysis too.

In this context, however, we understand a dynamic analysis as an examination of expected or potential changes compared to the status quo. It focuses on future developments. Hence, a dynamic analysis always involves a degree of uncertainty.

In combination with a PEST-Analysis, which reveals drivers for change in an industry, Porters Five Forces Analysis can reveal insights about the potential future attractiveness of the industry. Expected political, economical, socio-demographical and technological changes can influence the five competitive forces and thus have impact on industry structures.

Useful tools to determine potential changes of competitive forces are scenarios.

Analysis of Options

With the knowledge about the intensity and power of competitive forces, organizations can develop options to influence them in a way that improves their own competitive position. The result could be a new strategic direction, e.g. a new positioning, differentiation from competitive products or strategic partnerships (see section 4).

Scope of application of the Porters Five Forces model

Thus, Porters model of five competitive forces allows a systematic and structured analysis of market structures and competitive situations.

The model is typically described as a tool for industry analysis. However, depending on the actual question, it can be applied to particular companies, market segments, or regions to. In a given industry, all market players face the same five forces. The impact of these forces on any of these players may vary, do to different strategies, competences and processes of these players. Analogously, the same applies for specific market segments, regions or niches.

Therefore, it is necessary to determine the scope of the market to be analyzed in a first step. Following that, all relevant forces for this market are identified and analyzed. Hence, it is not always necessary to analyze all elements of all competitive forces with the same depth.

Influencing the Power of Five Forces

After the analysis of current and potential future states of the five competitive forces, managers can search for options to influence these forces in their organization's interest. Although industry-specific business models will limit options, the own strategy can change the impact of competitive forces on the organization. The objective is to reduce the power of competitive forces.

The following lists provide some examples. They are of general nature. According to the origin of the Porters Five Forces model, these examples mainly focus on traditional industries without much disruption and with moderate dynamics.

All of these ways to influence competitive forces have to be adjusted to each organization's specific situation. The options an organization has are determined not only by the external market environment, but also by its own internal resources, competences and objectives.

Reducing the Bargaining Power of Suppliers

- Partnering
- Supply chain management
- Supply chain training
- Increase supplier dependency and improve supplier relationships
- Have several suppliers compete against each other
- Build knowledge of suppliers costs and methods
- Take over a supplier

Reducing the Bargaining Power of Customers

- Partnering
- Supply chain management
- Increase loyalty
- Increase incentives and value added
- Move purchase decision away from price
- Cut put powerful intermediaries (go directly to final customer)

Reducing the Treat of New Entrants

- Increase minimum efficient scales of operations
- Create a strong brand (customer loyalty as a barrier)
- Patents, protection of intellectual property

- Alliances with linked products / services
- Tie up with suppliers
- Tie up with distributors
- Retaliation tactics
- Lobby for favorable regulation

Reducing the Threat of Substitutes

- Legal actions
- Lobby for favorable regulation
- Increase switching costs
- Alliances
- Customer surveys to learn about their preferences
- Enter substitute market and influence from within
- Accentuate differences (real or perceived)

Reducing the Competitive Rivalry between Existing Players

- Avoid price competition
- Differentiate your product
- Create a strong brand / build customer loyalty / increase switching costs for customers
- Buy out competition
- Reduce industry over-capacity
- Focus on different segments than competitors
- Communicate with competitors

Critique of the Porters Five Forces Model and relevance today

Porter's model of Five Competitive Forces has been subject of much critique. Its main weakness results from the historical context in which it was developed. Besides that, there are some general points of criticism too.

General points of criticism

In general, the meaningfulness of this model is reduced by the following factors:

As stated above, the Porters Five Forces model is based on microeconomics. The underlying theories assume a classic **perfect market**. Accordingly, this basic assumption applies to the Five Forces model too.
Most real-world industries are not perfect markets in an economical sense. They are, for instance, regulated and / or there are information imbalances among the market players.
Especially **regulation** limits the applicability of this model. In a highly regulated market, there aren't many competitive forces at work. Hence, their analysis will reveal limited insights.

The model is best applicable for the analysis of **simple market structures**. A comprehensive description and analysis of all five forces gets very difficult in complex industries with multiple interrelations, product groups, by-products, segments and intermediaries. A too narrow focus on particular segments of such industries, however, bears the risk of missing important forces.

The model is based on the idea of **competition**. It assumes that companies try to achieve competitive advantages over other players in the markets as well as over suppliers or customers. With this focus, it is less suitable to analyze highly collaborative markets

Not matching today's market dynamics

In the seventies and eighties of the last century, the global economy was characterized by cyclical growth and competition. Thus, profitability and survival were the primary corporate objectives. A major prerequisite for achieving these objectives has been optimization of strategy in relation to the external environment. The term 'competitive strategy' was coined.

At that time, development in most industries has been fairly stable and predictable, compared with today's dynamics.

Hence, the Porters Five Forces model assumes relatively **static market structures**. This is hardly the case in today's dynamic markets.

The business environment has changed since then. The term VUCA-world describes a new external environment of **V**olatility, **U**ncertainty, **C**omplexity and **A**mbiguity. Technological breakthroughs start-ups or market entrants from other industries may completely change business models, entry barriers and relationships along the supply chain within short times.

The Five Forces model may have some use for later analysis of the new situation; but it will hardly provide much meaningful advice for preventive actions.

Larry Downes stated in his article "Beyond Porter" from 1997 that these underlying assumptions of the model are no longer viable. He identified three new forces that require a new strategic framework and a set of very different analytic and business design tools: digitalization, globalization, and deregulation. (For a more detailed comment on Downes' critique of the Five Forces model see my article from 2001)

Overall, Porters Five Forces Model has some major limitations in today's market environment. It is not able to take into account new business models and the dynamics of markets. The value of Porters model is more that it enables managers to think about the current situation of their industry in a structured, easy-to-understand way – as a starting point for further analysis.

Our book recommendatins on competitive analysis

- Business and Competitive Analysis: Effective Application of New and Classic Methods
  Craig S. Fleisher and Babette E. Bensoussan
  The authors begin with a practical primer on the process and context of business and competitive analysis. They then present dozens of today's most valuable analysis methods. For every method, they present clear descriptions, background context, strategic rationales, strengths, weaknesses, step-by-step instructions, and references.
- The Secret Language of Competitive Intelligence: How to see through & stay ahead of business disruptions, distortions, rumors & smoke screens
  Leonard M. Fuld
  The author shows how to take data that is widely avail-able to everyone, think critically about it, and convert it into highly refined intelligence that leads to effective market-based decisions.
- Analysis Without Paralysis: 12 Tools to Make Better Strategic

Decisions

This book shows readers how to apply analytical tools without having to mire themselves in advanced math or arcane theory. It teaches readers the fundamentals of business analysis through the use of 12 core tools.