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Porter's Five Forces Model: Tips and Examples

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One of the biggest threats to a business – startup or established, small or Fortune 500 – is competition. Who is your competition? How are their actions in the marketplace going to affect your current bottom line and future planning?

To answer those questions, you must analyze the competition. One way to do that is by using Porter's Five Forces model to break them down into five distinct categories, designed to reveal insights.

Originally developed by Harvard Business School's Michael E. Porter in 1979, the five forces model looks at five specific factors that help determine whether or not a business can be profitable, based on other businesses in the industry.

"Understanding the competitive forces, and their underlying causes, reveals the roots of an industry's current profitability while providing a framework for anticipating and influencing competition (and profitability) over time," Porter wrote in a Harvard Business Review article. "A healthy industry structure should be as much a competitive concern to strategists as their company's own position."

According to Porter, the origin of profitability is identical regardless of industry. In that light, industry structure is what ultimately drives competition and profitability —not whether an industry produces a product or service, is emerging or mature, high-tech or low-tech, regulated or unregulated.

"If the forces are intense, as they are in such industries as airlines, textiles, and hotels, almost no company earns attractive returns on investment," Porter wrote. "If the forces are benign, as they are in industries such as software, soft drinks, and toiletries, many companies are profitable."

Understanding the Five Forces

Porter regarded understanding both the competitive forces and the overall industry structure as crucial for effective strategic decision-making. In Porter's model, the five forces that shape industry competition are:

1. Competitive rivalry

This force examines how intense the competition currently is in the marketplace, which is determined by the number of existing competitors and what each is capable of doing. Rivalry competition is high when there are just a few businesses equally selling a product or service, when the industry is growing and when consumers can easily switch to a competitor's offering for little cost. When rivalry competition is high, advertising and price wars can ensue, which can hurt a business's bottom line.

2. Bargaining power of suppliers

This force analyzes how much power a business's supplier has and how much control it has over the potential to raise its prices, which, in turn, would lower a business's profitability. In addition, it looks at the number of suppliers available: The fewer there are, the more power they have. Businesses are in a better position when there are a multitude of suppliers.

3. Bargaining power of customers

This force looks at the power of the consumer to affect pricing and quality. Consumers have power when there aren't many of them, but lots of sellers, as well as when it is easy to switch from one business's products or services to another. Buying power is low when consumers purchase products in small amounts and the seller's product is very different from any of its competitors.

4. Threat of new entrants

This force examines how easy or difficult it is for competitors to join the marketplace in the industry being examined. The easier it is for a competitor to join the marketplace, the greater the risk of a business's market share being depleted. Barriers to entry include absolute cost advantages, access to inputs, economies of scale and well-recognized brands.

5. Threat of substitute products or services

This force studies how easy it is for consumers to switch from a business's product or service to that of a competitor. It looks at how many competitors there are, how their prices and quality compare to the business being examined and how much of a profit those competitors are earning, which would determine if they can lower their costs even more. The threat of substitutes are informed by switching costs, both immediate and long-term, as well as a buyer's inclination to change.

Example of Porter's Five Forces

There are several examples of how Porter's Five Forces can be applied to various industries online. As an example, stock analysis firm Trefis looked at how Under Armour fits into the athletic footwear and apparel industry.

Competitive rivalry: Under Armour faces intense competition from Nike, Adidas and newer players. Nike and Adidas, which have considerably larger resources at their disposal, are making a play within the performance apparel market to gain market share in this up-and-coming product category. Under Armour does not hold any fabric or process patents, and hence its product portfolio could be copied in the future.

Bargaining power of suppliers: A diverse supplier base limits bargaining power. Under Armour's products are produced by dozens of manufacturers located across multiple countries.

Bargaining power of customers: Under Armour's customers include both wholesale customers as well as end customers. Wholesale customers, like Dick's Sporting Goods and the Sports

Authority, hold a certain degree of bargaining leverage, as they could substitute Under Armour's products with those of competitors to gain higher margins. Bargaining power of end customers is lower as Under Armour enjoys strong brand recognition.

Threat of new entrants: Large capital costs are required for branding, advertising and creating product demand, and hence limits the entry of newer players in the sports apparel market. However, existing companies in the sports apparel industry could enter the performance apparel market in the future.

Threat of substitute products: The demand for performance apparel, sports footwear and accessories is expected to continue, and hence we think this force does not threaten Under Armour in the foreseeable future.

Trefis has also completed Porter's Five Forces analyses of companies, including Facebook, Nike, Coach and Ralph Lauren.

Strategies for success

Once your analysis is complete, it is time to implement a strategy to expand your competitive advantage. To that end, Porter identified three generic strategies that can be implemented in any industry, and in companies of any size:

Cost leadership

Your goal is to increase profits by reducing costs while charging industry-standard prices, or to increase market share by reducing the sales price while retaining profits.

Differentiation

To implement this strategy, make the company's products significantly different from the competition, improving their competitiveness and value to the public. It requires both good research and development and effective sales and marketing teams.

Focus

A successful implementation means the company selects niche markets in which to sell their goods. It requires intense understanding of the marketplace, its sellers, buyers and competitors.

More information about the generic strategies is available in Porter's 1985 book, Competitive Advantage (Free Press).

Alternatives and addendums

While Porter's Five Forces is an effective and time-tested model, it has been criticized for failing to explain strategic alliances. In the 1990s, Yale School of Management professors Adam Brandenbuger and Bare Nalebuff created the idea of a sixth force, "complementors," using the tools of game theory. In their model, complementors sell products and services that are best used in conjunction with a product or service from a competitor. Intel, which manufactures processors, and computer manufacturer Apple could be considered complementors in this model. More information can be found at Strategic CFO.

Additional modeling tools are likely to help you round out your understanding of your business and its potential. A value chain analysis aims to help companies understand where they have the best productive advantage, while the BCG matrix helps companies identify which products are likely to benefit the most from increased investment.

Additional reporting by Katherine Arline and Chad Brooks. Some source interviews were conducted for a previous version of this article.