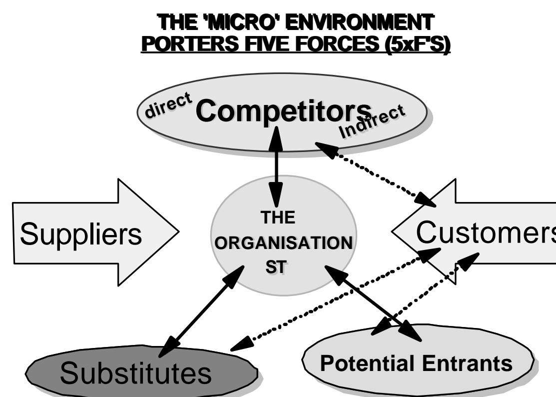
Porter's Five Forces

The following paper is an abridged version of Michael Porter's seminal HBR paper of 1979 – for more detail and examples the reader is recommended to refer to the original.

The Essentials of Strategy formulation is coping with the commercial and marketing environment in which the firm chooses to do business.
This environment can be usefully divided into two major categories – the Micro Environment which is primarily to do with all those forces which are deliberately trying to separate the firm from its customers; in other words the competition – which is the main thrust of this paper, and the Macro Environment which is to do with all the issues outside competition with which the firm has to deal, normally encapsulated in the acronym PLeESTT – which cannot be ignored but will not be examined here.

Intense competition in an industry is neither coincidence nor bad luck. Competition is rooted in the underlying economics of an industry, and these forces go well beyond the established and immediately identifiable combatants in that industry. Customers, Suppliers, Substitute products, potential new entrants and 'indirect competitors' are all threatening to deprive a firm of its business in the long and/or the short term.

The State of competition in any Market Place is dependent on the individual vigour of five basic forces as below:



The collective strength of these forces determine the ultimate profit potential of an industry – and in turn the ease with which profitability can be attained by any firm operating within it.

A Market that is said to be 'unstructured' [i.e. one where it take more than 20% of the firms in that industry to do 80% of the market's business] is characterised by intense margin eroding competition – and will require different strategies to be profitable compared to a structured market, where competition may be of a different order, but the threats from substitutes and new entrants, and the freedom from price competition can assist the firm to make more healthy margins.

Whatever the situation, the branch strategist's job is to seek a position in the Market where their company can firstly best defend itself, and secondly best take advantage of its Strengths and the Market's Opportunities.

These forces (SWOT) may be painfully apparent to all the protagonists in the market, but the strategist that succeeds is the one who delves below the surface and is able to analyse the sources of each. For example: -
Q. What makes the market vulnerable to new entry?
Or
Q. What determines the bargaining power of suppliers (or customers for that matter)?

Knowledge of these underlying sources of competitive pressure provides the groundwork for a strategic agenda of action.
They highlight the critical strengths and weaknesses of the company, animate the company's Market Position and clarify the areas where the strategic changes may be able to yield the greatest payoff.
Also this process highlights the places where the industry trends promise to hold the greatest significance as either Opportunities or Threats.

The strongest forces determine the potential for Profitability. Even in structured markets a strong incumbent competitor with superior low cost offerings can negate the absence of threat from new entrants.
The strategist wanting to position their company to cope best with the industry forces MUST understand them better than the competition.

Threat of New Entrants:
New entrants bring extra capacity to an industry, the desire to gain market share, and often-substantial resources to do so. Only rarely, such as in the early stages of the life cycle of a totally new product, when they help to grow the Market, are new entrants relatively benign. Mostly they are threats to be countered by the incumbents.
The best thing is to stop the threat before it emerges – if you can.

There are six major sources of barriers to entry:

1. Economies of Scale: - Scale economies of Production/Cost, Marketing, Distribution, R&D, at the behest of the incumbents, can be a potent deterrent to any outsider.
2. Product Differentiation: - either actual protectable differences (i.e. Copyright, Patents) or Strong Branding (e.g. Coca Cola, Intel, Nokia etc) can make a new entrant's incursion very expensive.
3. Capital Requirements: - the need to invest heavily in order to compete creates a strong barrier particularly if the investment is non recoverable (e.g. Advertising, R&D) is a powerful disincentive.
4. Cost Disadvantages: - Firms already entrenched often have the advantages of already having climbed the learning and experience curves which new entrants would have to pay for (a variant of 3 above).
5. Access to Distribution Channels: - they may often be well tied up by the incumbents, they may be at maximum capacity, in this case new entrants will often have to invent new Routes to Market.
6. Government Policy: - Governments can, and in some industries do restrict entry to some markets. This happens for example in the issuance of licences such as in telecommunications. It can also happen via the imposition of stringent application of standards such as in terms of health and safety, or in control of pollution in air or water etc.

Powerful Suppliers and Customers: -
Suppliers have power where they are few compared to the numbers of customers and/or it is more concentrated than the industry it sells to. Or where the product they sell is in strategic short supply and/or the product it sells has built up switching costs (i.e. the costs a buyer may have to incur when changing suppliers).

Some suppliers can sell direct to the buyer's customers (or threaten to do so) either direct or via integrating forward such as by acquiring one of the buyer's competition.

Powerful suppliers can squeeze the profitability out of an industry.

Sometimes (not always) it is in the Seller's interest to husband the industry it sells to. If that industry represents a strategically important aspect of its business, they will want to protect that industry via reasonable prices, and otherwise strong relationship building activities.

A Buyer Group is Powerful if: -

- It is concentrated and/or purchases in large volumes. These sorts of buyers are especially powerful if the industry is characterised by heavy Fixed Costs.
- The Product in question that it buys is a commodity – i.e. purchased on the basis of Specification, Availabi lity and/or Price alone.
- The Product in question is components of its own final product and forms a significant portion of that 'Original Equipment' (OE) cost. Here buyers will be very active in trying for the best price and the most stable relationship. For products that do not form such a substantial portion of the OE cost, buyers are often less active.
  CONVERSLY
- When the seller's product is unimportant to the quality etc. of the buyer's final Product (e.g. Office Cleaning)
- The buying firm has narrow margins that provide a great incentive for active purchasing strategies.
- The seller's product does not save the buyer money
- The buyer poses a credible threat of integrating backward to make the Seller's product itself.

STRATEGIC ACTION

A company's choice of suppliers, and customers should always be viewed as a crucial strategic decision.

A firm can improve its strategic posture via one of two possible extreme positions

i. By finding Seller's and Buyers who poses the least power to influence it adversely.

OR- conversely

ii. By choosing to join a chain of strong buyers and sellers who can promote its future i.e. they establish the 'wave' on which the company can surf – such as is the case with the Japanese 'Kiretsue'

Most commonly firms spend more effort on selecting customers than suppliers.

As a general rule, firms can only sell at above average profitability to powerful customers if they are Low Cost Producers OR if its own product has a strong Competitive Differential Advantage.

Substitute Products: -

By placing a ceiling on prices it can charge, a substitute product limits the profitability potential of an industry, e.g. private motorcars provide an alternative to Public Transport for most commuting.

Substitute products that deserve the most attention strategically are those that:

a) Are subject to trends improving their price-performance trade-off with the industry's product,

OR

b) Are produced by industries earning high profits.

Substitutes often come rapidly into play if some development increases competition in their industry and causes price reduction or performance improvements.

Jockeying for Position: -

This so often takes the form of either price competition, Product introductions, or an Advertising Slugfest. Intense rivalry is related to a number of factors: -

- Competitors are numerous and/or they are roughly equal in size and power,
- Industry growth is slow
- The product (Good or Service) lacks differentiation,
- Fixed costs are high and/or the product is perishable (e.g. Airlines) which creates a strong temptation to cut price.
- Capacity in the industry is usually augmented in large increments, these augmentations can lead to sudden increases in capacity which will lead to periods of overcapacity and hence price competition.
- Exit barriers for the incumbent firms are high. This for various reasons will mean that firms are either unable or reluctant to leave the industry, long after it was\ economically wise so to do.
- The incumbent rivals are diverse in strategies, origins and "personalities". They have different ideas about how to compete and continually run head on into each other in the process.

As an industry / Market matures, its growth rate changes (see Product Life Cycle). This results in declining profits and often a shakeout as the weakest go to the wall.

While a firm must learn to live with many of the above factors – they are part of the industry; the strategists should try to take the initiative by, for example:

- Raising the customer's costs associated with changing suppliers, by for example, increasing product differentiation.
- Focusing the sales effort on the fastest growing segments in the industry
- Avoiding confrontation with competitors, particularly those with high exit barriers, they must fight if challenged, and someone will get hurt.

Formulation of Strategy: -

Only AFTER having assessed the forces affecting competition in an industry AND their underlying causes can the corporate strategist identify the firm's relevant strengths and weaknesses. The crucial ones are the customer's posture vis a vis the underlying market causes. Where does the firm stand against Substitutes, Entry Barriers, Direct and Indirect Competition, possible New Entrants?

The strategist's subsequent design may include:

1. Positioning the firm to attract the best customers and defend itself against these competitive forces,
2. Influence the balance of forces through strategic moves in the industry,
3. Anticipating shifts in the underlying factors and responding to them before he competition.

Porter then goes on to discuss each of these in turn and in detail

IN SUMMARY:

A common mistake is for (branch) managers to concentrate on their direct competitors in their fight for market share, whilst failing to realise that they are also in a struggle for bargaining power with their suppliers and their customers in the market place.
Meanwhile they also commonly neglect the threats from Substitute Products and possible New Entrants.

The Key To Survival first, then to Growth – is for the firm to stake out a position in the market that has as little vulnerability to attack as possible, from any or all of these five forces. Establishing such a position can take many forms, from:

- establishing strong relationships with Key Customers,
- differentiating the Product substantively and/or psychologically,
- integrating either forward or backward - and
- establishing technological leadership.

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