**Porters 5 Forces**

[1       Introduction](http://www.themanager.org/Models/p5f.htm#_Toc516553132)

[2       The Five Competitive Forces](http://www.themanager.org/Models/p5f.htm#_Toc516553133)

[2.1         Bargaining Power of Suppliers](http://www.themanager.org/Models/p5f.htm#_Toc516553134)

[2.2         Bargaining Power of Customers](http://www.themanager.org/Models/p5f.htm#_Toc516553135)

[2.3         Threat of New Entrants](http://www.themanager.org/Models/p5f.htm#_Toc516553136)

[2.4         Threat of Substitutes](http://www.themanager.org/Models/p5f.htm#_Toc516553137)

[2.5         Competitive Rivalry between Existing Players](http://www.themanager.org/Models/p5f.htm#_Toc516553138)

[3       Use of the Information form Five Forces Analysis](http://www.themanager.org/Models/p5f.htm#_Toc516553139)

[4       Influencing the Power of Five Forces](http://www.themanager.org/Models/p5f.htm#_Toc516553140)

[4.1         Reducing the Bargaining Power of Suppliers](http://www.themanager.org/Models/p5f.htm#_Toc516553141)

[4.2         Reducing the Bargaining Power of Customers](http://www.themanager.org/Models/p5f.htm#_Toc516553142)

[4.3         Reducing the Treat of New Entrants](http://www.themanager.org/Models/p5f.htm#_Toc516553143)

[4.4         Reducing the Threat of Substitutes](http://www.themanager.org/Models/p5f.htm#_Toc516553144)

[4.5         Reducing the Competitive Rivalry between Existing Players](http://www.themanager.org/Models/p5f.htm#_Toc516553145)

[5       Critique](http://www.themanager.org/Models/p5f.htm#_Toc516553146)

# 1           Introduction

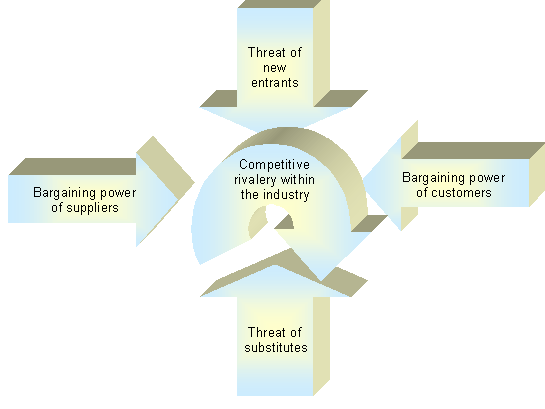
The model of the Five Competitive Forces was developed by Michael E. Porter in his book „Competitive Strategy: Techniques for Analyzing Industries and Competitors“ in 1980. Since that time it has become an important tool for analyzing an organizations industry structure in strategic processes.

Porters model is based on the insight that a corporate strategy should meet the opportunities and threats in the organizations external environment. Especially, competitive strategy should base on and 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. The objective of corporate strategy should be to modify these competitive forces in a way that improves the position of the organization. Porters model supports 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 characteristics of their industry.

# 2           The Five Competitive Forces

The Five Competitive Forces are typically described as follows:



## 2.1          Bargaining Power of Suppliers

The term 'suppliers' comprises all sources for inputs 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 of the supplier integrating 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 relationship to powerful suppliers can potentially reduce strategic options for the organization.

## 2.2          Bargaining Power of Customers

Similarly, the bargaining power of customers determines how much customers can impose pressure 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 integrating backwards.

## 2.3          Threat of New Entrants

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

The threat of new entries will depend 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

## 2.4          Threat of Substitutes

A threat from substitutes exists 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.

## 2.5          Competitive Rivalry between Existing Players

This force describes the intensity of competition between existing players (companies) in an industry. High competitive pressure results in 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).

# 3           Use of the Information form Five Forces Analysis

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

**Statical Analysis:**

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.

**Dynamical Analysis:**

In combination with a PEST-Analysis, which reveals drivers for change in an industry, 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 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 for competitive products of strategic partnerships (see section 4).

Thus, Porters model of Five Competitive Forces allows a systematic and structured analysis of market structure and competitive situation. The model can be applied to particular companies, market segments, industries or regions. Therefore, it is necessary to determine the scope of the market to be analyzed in a first step. Following, all relevant forces for this market are identified and analyzed. Hence, it is not necessary to analyze all elements of all competitive forces with the same depth.

The Five Forces Model is based on microeconomics. It takes 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.

# 4           Influencing the Power of Five Forces

After the analysis of current and potential future state 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 figure provides some examples. They are of general nature. Hence, they have to be adjusted to each organization’s specific situation. The options of an organization are determined not only by the external market environment, but also by its own internal resources, competences and objectives.

|  |  |
| --- | --- |
| 4.1          Reducing the Bargaining Power of Suppliers | 4.2          Reducing the Bargaining Power of Customers |
|           Partnering            Supply chain management            Supply chain training            Increase dependency            Build knowledge of supplier costs and methods            Take over a supplier |           Partnering            Supply chain management            Increase loyalty            Increase incentives and value added            Move purchase decision away from price            Cut put powerful intermediaries (go directly to customer) |
| 4.3          Reducing the Treat of New Entrants | 4.4          Reducing the Threat of Substitutes |
|           Increase minimum efficient scales of operations            Create a marketing / brand image (loyalty as a barrier)            Patents, protection of intellectual property            Alliances with linked products / services            Tie up with suppliers            Tie up with distributors            Retaliation tactics |           Legal actions            Increase switching costs            Alliances            Customer surveys to learn about their preferences            Enter substitute market and influence from within            Accentuate differences (real or perceived) |
| 4.5          Reducing the Competitive Rivalry between Existing Players |  |
|           Avoid price competition            Differentiate your product            Buy out competition            Reduce industry over-capacity            Focus on different segments            Communicate with competitors |

# 5           Critique

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. In the early eighties, cyclical growth characterized the global economy. Thus, primary corporate objectives consisted of profitability and survival. A major prerequisite for achieving these objectives has been optimization of strategy in relation to the external environment. At that time, development in most industries has been fairly stable and predictable, compared with today’s dynamics.

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

       In the economic sense, the model assumes a classic perfect market. The more an industry is regulated, the less meaningful insights the model can deliver.

       The model is best applicable for 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 and segments. A too narrow focus on particular segments of such industries, however, bears the risk of missing important elements.

       The model assumes relatively static market structures. This is hardly the case in today’s dynamic markets. Technological breakthroughs and dynamic market entrants from start-ups or 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.

       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 dos not really take into consideration strategies like strategic alliances, electronic linking of information systems of all companies along a value chain, virtual enterprise-networks or others.

 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.

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Porter's Five Forces

**A MODEL FOR INDUSTRY ANALYSIS**

The model of pure competition implies that risk-adjusted rates of return should be constant across firms and industries. However, numerous economic studies have affirmed that different industries can sustain different levels of profitability; part of this difference is explained by industry structure.

Michael Porter provided a framework that models an industry as being influenced by five forces. The strategic business manager seeking to develop an edge over rival firms can use this model to better understand the industry context in which the firm operates.

#### Diagram of Porter's 5 Forces

|  |  |  |
| --- | --- | --- |
|  | **SUPPLIER POWER**  Supplier concentration  Importance of volume to supplier  Differentiation of inputs  Impact of inputs on cost or differentiation  Switching costs of firms in the industry  Presence of substitute inputs  Threat of forward integration  Cost relative to total purchases in industry |  |
| **BARRIERS TO ENTRY**  Absolute cost advantages  Proprietary learning curve  Access to inputs  Government policy  Economies of scale  Capital requirements  Brand identity  Switching costs  Access to distribution  Expected retaliation  Proprietary products | RIVALRY | **THREAT OF SUBSTITUTES**  -Switching costs  -Buyer inclination to  substitute  -Price-performance  trade-off of substitutes |
|  | **BUYER POWER**  Bargaining leverage  Buyer volume  Buyer information  Brand identity  Price sensitivity  Threat of backward integration  Product differentiation  Buyer concentration vs. industry  Substitutes available  Buyers' incentives | **DEGREE OF RIVALRY**  -Exit barriers  -Industry concentration  -Fixed costs/Value added  -Industry growth  -Intermittent overcapacity  -Product differences  -Switching costs  -Brand identity  -Diversity of rivals  -Corporate stakes |

**I. Rivalry**

In the traditional economic model, competition among rival firms drives profits to zero. But competition is not perfect and firms are not unsophisticated passive price takers. Rather, firms strive for a [competitive advantage](http://www.quickmba.com/strategy/competitive-advantage/) over their rivals. The intensity of rivalry among firms varies across industries, and strategic analysts are interested in these differences.

Economists measure rivalry by indicators of  [industry concentration](http://www.quickmba.com/econ/micro/indcon.shtml). The Concentration Ratio (CR) is one such measure. The Bureau of Census periodically reports the CR for major Standard Industrial Classifications (SIC's). The CR indicates the percent of [market share](http://www.quickmba.com/marketing/market-share/) held by the four largest firms (CR's for the largest 8, 25, and 50 firms in an industry also are available). A high concentration ratio indicates that a high concentration of market share is held by the largest firms - the industry is concentrated. With only a few firms holding a large market share, the competitive landscape is less competitive (closer to a monopoly). A low concentration ratio indicates that the industry is characterized by many rivals, none of which has a significant market share. These *fragmented* markets are said to be competitive. The concentration ratio is not the only available measure; the trend is to define industries in terms that convey more information than distribution of market share.

If rivalry among firms in an industry is low, the industry is considered to be disciplined. This discipline may result from the industry's history of competition, the role of a leading firm, or informal compliance with a generally understood code of conduct. Explicit *collusion* generally is illegal and not an option; in low-rivalry industries competitive moves must be constrained informally. However, a maverick firm seeking a competitive advantage can displace the otherwise disciplined market.

When a rival acts in a way that elicits a counter-response by other firms, rivalry intensifies. The intensity of rivalry commonly is referred to as being cutthroat, intense, moderate, or weak, based on the firms' aggressiveness in attempting to gain an advantage.

In pursuing an advantage over its rivals, a firm can choose from several competitive moves:

* Changing prices - raising or lowering prices to gain a temporary advantage.
* Improving product differentiation - improving features, implementing innovations in the manufacturing process and in the product itself.
* Creatively using channels of distribution - using [vertical integration](http://www.quickmba.com/strategy/vertical-integration/) or using a distribution channel that is novel to the industry. For example, with high-end jewelry stores reluctant to carry its watches, Timex moved into drugstores and other non-traditional outlets and cornered the low to mid-price watch market.
* Exploiting relationships with suppliers - for example, from the 1950's to the 1970's Sears, Roebuck and Co. dominated the retail household appliance market. Sears set high quality standards and required suppliers to meet its demands for product specifications and price.

The intensity of rivalry is influenced by the following industry characteristics:

1. **A larger number of firms** increases rivalry because more firms must compete for the same customers and resources. The rivalry intensifies if the firms have similar market share, leading to a struggle for market leadership.
2. **Slow market growth** causes firms to fight for market share. In a growing market, firms are able to improve revenues simply because of the expanding market.
3. **High fixed costs** result in an economy of scale effect that increases rivalry. When total costs are mostly fixed costs, the firm must produce near capacity to attain the lowest unit costs. Since the firm must sell this large quantity of product, high levels of production lead to a fight for market share and results in increased rivalry.
4. **High storage costs or highly perishable products** cause a producer to sell goods as soon as possible. If other producers are attempting to unload at the same time, competition for customers intensifies.
5. **Low switching costs** increases rivalry. When a customer can freely switch from one product to another there is a greater struggle to capture customers.
6. **Low levels of product differentiation** is associated with higher levels of rivalry. Brand identification, on the other hand, tends to constrain rivalry.
7. **Strategic stakes are high** when a firm is losing market position or has potential for great gains. This intensifies rivalry.
8. **High exit barriers** place a high cost on abandoning the product. The firm must compete. High exit barriers cause a firm to remain in an industry, even when the venture is not profitable. A common exit barrier is asset specificity. When the plant and equipment required for manufacturing a product is highly specialized, these assets cannot easily be sold to other buyers in another industry. Litton Industries' acquisition of Ingalls Shipbuilding facilities illustrates this concept. Litton was successful in the 1960's with its contracts to build Navy ships. But when the Vietnam war ended, defense spending declined and Litton saw a sudden decline in its earnings. As the firm restructured, divesting from the shipbuilding plant was not feasible since such a large and highly specialized investment could not be sold easily, and Litton was forced to stay in a declining shipbuilding market.
9. **A diversity of rivals** with different cultures, histories, and philosophies make an industry unstable. There is greater possibility for mavericks and for misjudging rival's moves. Rivalry is volatile and can be intense. The hospital industry, for example, is populated by hospitals that historically are community or charitable institutions, by hospitals that are associated with religious organizations or universities, and by hospitals that are for-profit enterprises. This mix of philosophies about mission has lead occasionally to fierce local struggles by hospitals over who will get expensive diagnostic and therapeutic services. At other times, local hospitals are highly cooperative with one another on issues such as community disaster planning.
10. **Industry Shakeout.** A growing market and the potential for high profits induces new firms to enter a market and incumbent firms to increase production. A point is reached where the industry becomes crowded with competitors, and demand cannot support the new entrants and the resulting increased supply. The industry may become crowded if its growth rate slows and the market becomes saturated, creating a situation of excess capacity with too many goods chasing too few buyers. A shakeout ensues, with intense competition, price wars, and company failures.

BCG founder Bruce Henderson generalized this observation as the Rule of Three and Four: a stable market will not have more than three significant competitors, and the largest competitor will have no more than four times the market share of the smallest. If this rule is true, it implies that:

* + If there is a larger number of competitors, a shakeout is inevitable
  + Surviving rivals will have to grow faster than the market
  + Eventual losers will have a negative cash flow if they attempt to grow
  + All except the two largest rivals will be losers
  + The definition of what constitutes the "market" is strategically important.

Whatever the merits of this rule for stable markets, it is clear that market stability and changes in supply and demand affect rivalry. Cyclical demand tends to create cutthroat competition. This is true in the disposable diaper industry in which demand fluctuates with birth rates, and in the greeting card industry in which there are more predictable business cycles.

**II. Threat Of Substitutes**

In Porter's model, substitute products refer to products in other industries. To the economist, a threat of substitutes exists when a product's demand is affected by the price change of a substitute product. A product's [price elasticity](http://www.quickmba.com/econ/micro/elas/ped.shtml) is affected by substitute products - as more substitutes become available, the demand becomes more elastic since customers have more alternatives. A close substitute product constrains the ability of firms in an industry to raise prices.

The competition engendered by a Threat of Substitute comes from products outside the industry. The price of aluminum beverage cans is constrained by the price of glass bottles, steel cans, and plastic containers. These containers are substitutes, yet they are not rivals in the aluminum can industry. To the manufacturer of automobile tires, tire retreads are a substitute. Today, new tires are not so expensive that car owners give much consideration to retreading old tires. But in the trucking industry new tires are expensive and tires must be replaced often. In the truck tire market, retreading remains a viable substitute industry. In the disposable diaper industry, cloth diapers are a substitute and their prices constrain the price of disposables.

While the treat of substitutes typically impacts an industry through price competition, there can be other concerns in assessing the threat of substitutes. Consider the substitutability of different types of TV transmission: local station transmission to home TV antennas via the airways versus transmission via cable, satellite, and telephone lines. The new technologies available and the changing structure of the entertainment media are contributing to competition among these substitute means of connecting the home to entertainment. Except in remote areas it is unlikely that cable TV could compete with free TV from an aerial without the greater diversity of entertainment that it affords the customer.

**III. Buyer Power**

The power of buyers is the impact that customers have on a producing industry. In general, when buyer power is strong, the relationship to the producing industry is near to what an economist terms a **monopsony** - a market in which there are many suppliers and one buyer. Under such market conditions, the buyer sets the price. In reality few pure monopsonies exist, but frequently there is some asymmetry between a producing industry and buyers. The following tables outline some factors that determine buyer power.

|  |  |
| --- | --- |
| **Buyers are Powerful if:** | **Example** |
| Buyers are concentrated - there are a few buyers with significant market share | DOD purchases from defense contractors |
| Buyers purchase a significant proportion of output - distribution of purchases or if the product is standardized | Circuit City and Sears' large retail market provides power over appliance manufacturers |
| Buyers possess a credible backward integration threat - can threaten to buy producing firm or rival | Large auto manufacturers' purchases of tires |
|  | |
| **Buyers are Weak if:** | **Example** |
| Producers threaten forward integration - producer can take over own distribution/retailing | Movie-producing companies have integrated forward to acquire theaters |
| Significant buyer switching costs - products not standardized and buyer cannot easily switch to another product | IBM's 360 system strategy in the 1960's |
| Buyers are fragmented (many, different) - no buyer has any particular influence on product or price | Most consumer products |
| Producers supply critical portions of buyers' input - distribution of purchases | Intel's relationship with PC manufacturers |

**IV. Supplier Power**

A producing industry requires raw materials - labor, components, and other supplies. This requirement leads to buyer-supplier relationships between the industry and the firms that provide it the raw materials used to create products. Suppliers, if powerful, can exert an influence on the producing industry, such as selling raw materials at a high price to capture some of the industry's profits. The following tables outline some factors that determine supplier power.

|  |  |
| --- | --- |
| **Suppliers are Powerful if:** | **Example** |
| Credible forward integration threat by suppliers | Baxter International, manufacturer of hospital supplies, acquired American Hospital Supply, a distributor |
| Suppliers concentrated | Drug industry's relationship to hospitals |
| Significant cost to switch suppliers | Microsoft's relationship with PC manufacturers |
| Customers Powerful | Boycott of grocery stores selling non-union picked grapes |
|  | |
| **Suppliers are Weak if:** | **Example** |
| Many competitive suppliers - product is standardized | Tire industry relationship to automobile manufacturers |
| Purchase commodity products | Grocery store brand label products |
| Credible backward integration threat by purchasers | Timber producers relationship to paper companies |
| Concentrated purchasers | Garment industry relationship to major department stores |
| Customers Weak | Travel agents' relationship to airlines |

**V. Barriers to Entry / Threat of Entry**

It is not only incumbent rivals that pose a threat to firms in an industry; the possibility that new firms may enter the industry also affects competition. In theory, any firm should be able to enter and exit a market, and if free entry and exit exists, then profits always should be nominal. In reality, however, industries possess characteristics that protect the high profit levels of firms in the market and inhibit additional rivals from entering the market. These are ***barriers to entry***.

Barriers to entry are more than the normal equilibrium adjustments that markets typically make. For example, when industry profits increase, we would expect additional firms to enter the market to take advantage of the high profit levels, over time driving down profits for all firms in the industry. When profits decrease, we would expect some firms to exit the market thus restoring a market equilibrium. Falling prices, or the expectation that future prices will fall, deters rivals from entering a market. Firms also may be reluctant to enter markets that are extremely uncertain, especially if entering involves expensive start-up costs. These are normal accommodations to market conditions. But if firms individually (collective action would be illegal collusion) keep prices artificially low as a strategy to prevent potential entrants from entering the market, such **entry-deterring pricing** establishes a barrier.

Barriers to entry are unique industry characteristics that define the industry. Barriers reduce the rate of entry of new firms, thus maintaining a level of profits for those already in the industry. From a strategic perspective, barriers can be created or exploited to enhance a firm's competitive advantage. Barriers to entry arise from several sources:

1. **Government creates barriers.** Although the principal role of the government in a market is to preserve competition through anti-trust actions, government also restricts competition through the granting of monopolies and through regulation. Industries such as utilities are considered natural monopolies because it has been more efficient to have one electric company provide power to a locality than to permit many electric companies to compete in a local market. To restrain utilities from exploiting this advantage, government permits a monopoly, but regulates the industry. Illustrative of this kind of barrier to entry is the local cable company. The franchise to a cable provider may be granted by competitive bidding, but once the franchise is awarded by a community a monopoly is created. Local governments were not effective in monitoring price gouging by cable operators, so the federal government has enacted legislation to review and restrict prices.

The regulatory authority of the government in restricting competition is historically evident in the banking industry. Until the 1970's, the markets that banks could enter were limited by state governments. As a result, most banks were local commercial and retail banking facilities. Banks competed through strategies that emphasized simple marketing devices such as awarding toasters to new customers for opening a checking account. When banks were deregulated, banks were permitted to cross state boundaries and expand their markets. Deregulation of banks intensified rivalry and created uncertainty for banks as they attempted to maintain market share. In the late 1970's, the strategy of banks shifted from simple marketing tactics to mergers and geographic expansion as rivals attempted to expand markets.

1. **Patents and proprietary knowledge serve to restrict entry into an industry.** Ideas and knowledge that provide competitive advantages are treated as private property when patented, preventing others from using the knowledge and thus creating a barrier to entry. Edwin Land introduced the Polaroid camera in 1947 and held a monopoly in the instant photography industry. In 1975, Kodak attempted to enter the instant camera market and sold a comparable camera. Polaroid sued for patent infringement and won, keeping Kodak out of the instant camera industry.
2. **Asset specificity inhibits entry into an industry.** Asset specificity is the extent to which the firm's assets can be utilized to produce a different product. When an industry requires highly specialized technology or plants and equipment, potential entrants are reluctant to commit to acquiring specialized assets that cannot be sold or converted into other uses if the venture fails. Asset specificity provides a barrier to entry for two reasons: First, when firms already hold specialized assets they fiercely resist efforts by others from taking their market share. New entrants can anticipate aggressive rivalry. For example, Kodak had much capital invested in its photographic equipment business and aggressively resisted efforts by Fuji to intrude in its market. These assets are both large and industry specific. The second reason is that potential entrants are reluctant to make investments in highly specialized assets.
3. **Organizational (Internal) Economies of Scale.** The most cost efficient level of production is termed **Minimum Efficient Scale** (MES). This is the point at which unit costs for production are at minimum - i.e., the most cost efficient level of production. If MES for firms in an industry is known, then we can determine the amount of market share necessary for low cost entry or cost parity with rivals. For example, in long distance communications roughly 10% of the market is necessary for MES. If sales for a long distance operator fail to reach 10% of the market, the firm is not competitive.

The existence of such an economy of scale creates a barrier to entry. The greater the difference between industry MES and entry unit costs, the greater the barrier to entry. So industries with high MES deter entry of small, start-up businesses. To operate at less than MES there must be a consideration that permits the firm to sell at a premium price - such as product differentiation or local monopoly.

Barriers to exit work similarly to barriers to entry. Exit barriers limit the ability of a firm to leave the market and can exacerbate rivalry - unable to leave the industry, a firm must compete. Some of an industry's entry and exit barriers can be summarized as follows:

|  |  |
| --- | --- |
| **Easy to Enter if there is:**   * Common technology * Little brand franchise * Access to distribution channels * Low scale threshold | **Difficult to Enter if there is:**   * Patented or proprietary know-how * Difficulty in brand switching * Restricted distribution channels * High scale threshold |
| **Easy to Exit if there are:**   * Salable assets * Low exit costs * Independent businesses | **Difficult to Exit if there are:**   * Specialized assets * High exit costs * Interrelated businesses |

**DYNAMIC NATURE OF INDUSTRY RIVALRY**

Our descriptive and analytic models of industry tend to examine the industry at a given state. The nature and fascination of business is that it is not static. While we are prone to generalize, for example, list GM, Ford, and Chrysler as the "Big 3" and assume their dominance, we also have seen the automobile industry change. Currently, the entertainment and communications industries are in flux. Phone companies, computer firms, and entertainment are merging and forming strategic alliances that re-map the information terrain. Schumpeter and, more recently, Porter have attempted to move the understanding of industry competition from a static economic or industry organization model to an emphasis on the interdependence of forces as dynamic, or *punctuated equilibrium*, as Porter terms it.

In Schumpeter's and Porter's view the dynamism of markets is driven by innovation. We can envision these forces at work as we examine the following changes:

**Top 10 US Industrial Firms by Sales 1917 - 1988**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **1917** | **1945** | **1966** | **1983** | **1988** |
| 1 | US Steel | General Motors | General Motors | Exxon | General Motors |
| 2 | Swift | US Steel | Ford | General Motors | Ford |
| 3 | Armour | Standard Oil -NJ | Standard Oil -NJ (Exxon) | Mobil | Exxon |
| 4 | American Smelting | US Steel | General Electric | Texaco | IBM |
| 5 | Standard Oil -NJ | Bethlehem Steel | Chrysler | Ford | General Electric |
| 6 | Bethlehem Steel | Swift | Mobil | IBM | Mobil |
| 7 | Ford | Armour | Texaco | Socal (Oil) | Chrysler |
| 8 | DuPont | Curtiss-Wright | US Steel | DuPont | Texaco |
| 9 | American Sugar | Chrysler | IBM | Gulf Oil | DuPont |
| 10 | General Electric | Ford | Gulf Oil | Standard Oil of Indiana | Philip Morris |

**10 Largest US Firms by Assets, 1909 and 1987**

|  |  |  |
| --- | --- | --- |
|  | **1909** | **1987** |
| 1 | US STEEL | GM (Not listed in 1909) |
| 2 | STANDARD OIL, NJ (Now, EXXON #3) | SEARS (1909 = 45) |
| 3 | AMERICAN TOBACCO (Now, American Brands #52) | EXXON (Standard Oil trust broken up in 1911) |
| 4 | AMERICAN MERCANTILE MARINE (Renamed US Lines; acquired by Kidde, Inc., 1969; sold to McLean Industries, 1978; bankruptcy, 1986 | IBM (Ranked 68, 1948) |
| 5 | INTERNATIONAL HARVESTER (Renamed Navistar #182); divested farm equipment | FORD (Listed in 1919) |
| 6 | ANACONDA COPPER (acquired by ARCO in 1977) | MOBIL OIL |
| 7 | US LEATHER (Liquidated in 1935) | GENERAL ELECTRIC (1909= 16) |
| 8 | ARMOUR (Merged in 1968 with General Host; in 1969 by Greyhound; 1983 sold to ConAgra) | CHEVRON (Not listed in 1909) |
| 9 | AMERICAN SUGAR REFINING (Renamed AMSTAR. In 1967 =320)  Leveraged buyout and sold in pieces) | TEXACO (1909= 91) |
| 10 | PULLMAN, INC (Acquired by Wheelabrator Frye, 1980; spun-off as Pullman-Peabody, 1981; 1984 sold to Trinity Industries) | DU PONT (1909= 29) |

**GENERIC STRATEGIES TO COUNTER THE FIVE FORCES**

Strategy can be formulated on three [levels](http://www.quickmba.com/strategy/levels/):

* corporate level
* business unit level
* functional or departmental level.

The business unit level is the primary context of industry rivalry. Michael Porter identified three [generic strategies](http://www.quickmba.com/strategy/generic.shtml) (*cost leadership*, *differentiation*, and *focus*) that can be implemented at the business unit level to create a competitive advantage. The proper generic strategy will position the firm to leverage its strengths and defend against the adverse effects of the five forces.

**Recommended Reading**

Porter, Michael E., [*Competitive Strategy:*](http://www.amazon.com/exec/obidos/ASIN/0684841487/quickmba) *Techniques for Analyzing Industries and Competitors*

*Competitive Strategy* is the basis for much of modern business strategy. In this classic work, Michael Porter presents his five forces and generic strategies, then discusses how to recognize and act on market signals and how to forecast the evolution of industry structure. He then discusses competitive strategy for emerging, mature, declining, and fragmented industries. The last part of the book covers strategic decisions related to vertical integration, capacity expansion, and entry into an industry. The book concludes with an appendix on how to conduct an industry analysis.

# porter's five forces model

## Michael E Porter's five forces of competitive position model and diagrams

Michael Porter's famous Five Forces of Competitive Position model provides a simple perspective for assessing and analysing the competitive strength and position of a corporation or business organization. [A free Five Forces diagram in MSWord is available here](http://www.businessballs.com/../freematerialsinword/porter'sfiveforcesdiagram.doc). ([Porter's Five Forces diagram pdf here.](http://www.businessballs.com/portersfiveforcesdiagram.pdf))

American Michael Porter was born in 1947. After initially graduating in aeronautical engineering, Porter achieved an economics doctorate at Harvard, where he was subsequently awarded university professorship, a position he continues to fulfil at Harvard Business School. His research group is based at the Harvard Business School, and separately he co-founded with Mark Kramer the Foundation Strategy Group, 'a mission-driven social enterprise, dedicated to advancing the practice of philanthropy and corporate social investment, through consulting to foundations and corporations'. A prime example of someone operating at a [self-actualization](http://www.businessballs.com/maslow.htm) level if ever there was one.

After his earlier work on corporate strategy Porter extended the application of his ideas and theories to international economies and the competitive positioning of nations, as featured in his later books. In fact in 1985 Porter was appointed to President Ronald Reagan's Commission on Industrial Competitiveness, which marked the widening of his perspective to national economies. By the 1990's Porter had established a reputation as a strategy guru on the international speaking circuit second only to Tom Peters, and was among the world's highest earning academics.

Porter's first book Competitive Strategy (1980), which he wrote in his thirties, became an international best seller, and is considered by many to be a seminal and definitive work on corporate strategy. The book, which has been published in nineteen languages and re-printed approaching sixty times, changed the way business leaders thought and remains a guide of choice for strategic managers the world over.

Aside from his innovative thinking, Porter has a special ability to represent complex concepts in relatively easily accessible formats, notably his Five Forces model, in which market factors can be analysed so as to make a strategic assessment of the competitive position of a given supplier in a given market. The five forces that Porter suggests drive competition are:

## porter's five forces

1. **Existing competitive rivalry between suppliers**
2. **Threat of new market entrants**
3. **Bargaining power of buyers**
4. **Power of suppliers**
5. **Threat of substitute products (including technology change)**

Typically this five forces model is shown as a series of five boxes in a cross formation, item 1 being central. ([Pdf diagram here](http://www.businessballs.com/portersfiveforcesdiagram.pdf" \t "_blank), [MSWord diagram here](http://www.businessballs.com/../freematerialsinword/porter'sfiveforcesdiagram.doc).)

Porter's Five Forces model can be used to good analytical effect alongside other models such as the [SWOT](http://www.businessballs.com/swotanalysisfreetemplate.htm) and [PEST](http://www.businessballs.com/pestanalysisfreetemplate.htm) analysis tools.

Porter's Five Forces model provides suggested points under each main heading, by which you can develop a broad and sophisticated analysis of competitive position, as might be used when creating strategy, plans, or making investment decisions about a business or organization.

Porter is also known for his simple identification of five generic descriptions of industries:

1. **Fragmented** (eg, shoe repairs, gift shops)
2. **Emerging** (eg, space travel)
3. **Mature** (eg, automotive)
4. **Declining** (eg, solid fuels)
5. **Global** (eg, micro-processors)

And Porter is also particularly recognised for his competitive 'diamond' model, used for assessing relative competitive strength of nations, and by implication their industries:

1. **Factor Conditions:** production factors required for a given industry, eg., skilled labour, logistics and infrastructure.
2. **Demand Conditions:** extent and nature of demand within the nation concerned for the product or service.
3. **Related Industries:** the existence, extent and international competitive strength of other industries in the nation concerned that support or assist the industry in question.
4. **Corporate Strategy, Structure and Rivalry:** the conditions in the home market that affect how corporations are created, managed and grown; the idea being that firms that have to fight hard in their home market are more likely to be able to succeed in international markets.

Michael Porter's key books:

Competitive Strategy: Techniques for Analyzing Industries and Competitors, 1980   
Competitive Advantage: Creating and Sustaining Superior Performance, 1985   
Competition in Global Industries, 1986   
The Competitive Advantage of Nations, 1990

See also:

[SWOT analysis template](http://www.businessballs.com/swotanalysisfreetemplate.htm)

[PEST analysis template](http://www.businessballs.com/pestanalysisfreetemplate.htm)

[business and marketing planning process and templates](http://www.businessballs.com/freebusinessplansandmarketingtemplates.htm)