Business Club

Porter’s Five Forces

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What are Porter's Five Forces?

Porter's Five Forces are factors that are used to analyze the competition of a business or industry. This analysis helps us identify the profitability and attractiveness of an industry. These Forces are:

I. **Threat of new entrants**
II. **Threat of substitutes**
III. **Bargaining power of customers**
IV. **Bargaining power of suppliers**
V. **Intensity of Competitive Rivalry**

Threat of new entrants

This factor looks into how easy or difficult it is for a new competitor to enter the market. Industries with high return in profit will likely attract many new entrants. This, however, depletes the market share for existing companies and reduces their power. Numerous industries have barriers that make it harder for new entrants to establish themselves - licenses, patents etc. are ways of securing incumbents against a steep decline in profits. Some factors that determine the threat of new entrants are:

- **Product differentiation:** A higher amount of possible ways to differentiate products from competitors draws more new entrants as it gives them an opportunity to provide the market with something new (a new flavour, newer design etc.)

- **Expected competition:** If the industry is highly competitive, it is likely to deter new entrants as they stand lesser chances of being able to squeeze out profits from an already saturated space

- **Finances/Capital:** A capital intensive industry (an industry where companies require a larger amount of money to begin business) attracts fewer new entrants owing to the fact that financing larger amounts is tougher

- **Distribution channels and network**

- **Brand reputation/Customer Loyalty**: In an industry where this factor is important (e.g. medicine), new entrants find it tough to make a mark as customers are apprehensive about shifting products

- **Barriers to entry** (Patents, Government policies)

Threat of Substitutes

A substitute is anything that can be used to replace a firm's product or service. The substitute provides the same service and fulfills the same need, just with a different technology. Substitutes weaken the hold of a particular company by reducing the consumption of any company's products or services. Some factors that determine the threat of substitutes are:

- **Price to performance ratio of substitute:** Lower the value of this factor, higher is the probability of the substitute being preferred as it guarantees a better performance at a lower price
- **Availability of substitute:** A greater availability of the substitute may draw more customers towards it
- **Switching cost of substitution:** High costs of switching deters consumers from opting for alternative products
- **Available number of substitutes:** Intuitively, greater number of substitutes means a plethora of options for the consumer to opt from, reducing the influence of any particular firm over the industry

Bargaining power of Suppliers

This factor looks at the power that suppliers - who supply raw material, labor and other services - have over firms. They can do this by regulating the prices of their products. Suppliers can directly affect a company's profitability by raising or lowering prices. The fewer the suppliers, the more power they have over their customers as the latter has fewer alternatives to choose from. In fact, in cases of oligopoly, the suppliers often raise prices in coordination with each other to take away larger profits. Some factors that determine the bargaining power of suppliers are:

- **Cost of switching suppliers for the firm:** Higher the cost of switching, lesser the chances that the firm switches suppliers
- **Competition/number of suppliers:** A higher number of suppliers would mean more alternatives for the firm, thus reducing the supplier's power over negotiations
- **Product Substitutes:** If there are more substitutes for the supplier's product, the firm can opt for those alternatives thus reducing the supplier's bargaining power

- **Firm loyalty:** Suppliers can often benefit in an industry where firm loyalty is an influential factor as that implies lesser possibility of the latter switching suppliers

Bargaining power of Customers

The bargaining power of customers is the power customers have over a firm. Customers have great power over driving prices set by firms on its products. This depends on many factors:

- **Number of customers of a firm:** A higher number of customers ensures more bargaining power for the firm, as it gives them more alternatives
- **Cost of switching products/services:** As explained before, a higher switching cost deters consumers from choosing alternatives, which adds to the bargaining power of a firm
- **Availability/Prices of substitutes:** The prices and availability of substitutes govern how much bargaining power a firm can have - if a substitute is more accessible and performs better at the same/lower prices, it is more likely to be opted
- **Customer loyalty:** A firm benefits in industries where customer loyalty is an influential factor as it gives them more power to govern prices without losing customers
- **Uniqueness of product:** If a product is unique in ways and hard to imitate, it is more likely that the firm profits from it as it can rarely have substitutes

Intensity of competitive rivalry

Industry rivalry is one of the prime factors that determines the competitiveness and profitability of a firm. Rivalries keep prices and products competitive. The more competitive the company is, the more dominant it will be. Newer entrants are deterred by industries with high rivalry as it is harder to realize profits from such industries. More often than not, it is thought that industries with lesser firms have greater rivalries(e.g. Coca Cola and Pepsi). Although that may seem true, a deeper knowledge unveils the fact that industries with more number of firms have more intense rivalries as there are a larger number of players fighting for the same amount of industry turnover. Some factors that determine rivalry are:

- **Competitive Strategy**
- **Advertising Strategy**
- **Innovation by firms**
- **Number of firms/customers**

Case Study: **The Pizza Chain Industry**

Threat of New Entrants

- Entry into the Pizza Chain business is not easy. Pizza chains suffer from blows due to increased ingredient prices, slim margins and stiff competition
- An already existing chain like Pizza Hut has an advantage over the new competitor in terms of technology, resources and experience
- Relationships with the supplier matters a lot in the pizza industry. This helps keep the cost of production low in order to increase profitability
- In such an industry, customer loyalty is a powerful factor and Pizza chains have hordes of loyal customers who swear by their pizzas

Verdict: **Low**

Threat of Substitutes

- Apart from pizzerias, there are other substitutes available in the fast food segment like KFC, Burger King, Taco Bell, Subway and even family restaurants etc.
- The quickly growing demands for the packed food and ready-to-eat instant food items including frozen pizzas are absorbing a lot of customers from pizza chains as a whole
- There are other substitutes also available to pizza market such as the local super markets who not only provide frozen pizzas but also sell ready-to-bake pizzas and often large size pizza which is a major setback

Verdict: **High**

Bargaining Power of Customers

- Fast food consumers are large in number and most of them rely on few options
- Individual customers are unlikely to purchase a large amount of pizzas, hence individual customers do not affect overall sales
- Quick Service Restaurants are in high demand especially in malls, colleges, office arenas etc. Consequently, pizzas are quite inelastic to the price fluctuations with this section of people.

Verdict: **Low**

Bargaining Power of Suppliers

- There is a huge diversified supply chain available for its ingredients and raw materials
- Supplier's don't find themselves in a strong bargaining position as the core ingredient for the this food industry are widely available (flour, cheese, sauce etc.)
- Labour is also abundant and cheap for this labour intensive industry.
- Suppliers tend to keep long term relationships with the purchasers thereby making it easier for the purchasers to negotiate on lower prices

Verdict: **Low**

Intensity of Competitive Rivalry

- Stiff competition among fast food chains such as Domino's, McDonald's, KFC, Subway etc.
- Fierce price discounting, coupons, fast home deliveries and special customer offers have intensified the competition while also cutting down margins
- Apart from this established competition, there is competition from local pizzerias who provide a lot of innovative options, deliver faster and charge lesser

Verdict: **High**

Limitations

- Porter's Five Forces is essentially a snapshot analysis. In a rapidly evolving world like ours, with globalisation and fast pace of technological changes, the Porter's Analysis fails to capture all aspects
- A lot of people use Porter's five forces in ways it was never intended to be. Trying to apply Porter's five forces to a specific business rather than an industry as a whole is the most common mistake. Porter's five forces can provide information to enlighten strategic discussions, but it isn't a business level analysis tool.
- Another challenge in apply Porter's five forces is defining the industry clearly. Companies can straddle multiple industries depending on their business lines. They can't group companies with similar business lines and call it an industry.
- Not all factors are equally influential. In a world that has seen massive amounts of deregulation and barrier removal, threat of new entry has increased several folds, especially while considering international players.

Resources

- http://www.investopedia.com/terms/s/six-forces-model.asp
- http://www.investopedia.com/articles/investing/103116/pitfalls-porters-5-forces.asp#ixzz4xYKn9fO6
- https://en.wikipedia.org/wiki/Porter%27s_five_forces_analysis
- https://www.youtube.com/watch?v=33XmkfbzwO8
- Foundations of Business Strategy, Darden School of Business