Porters Five Forces

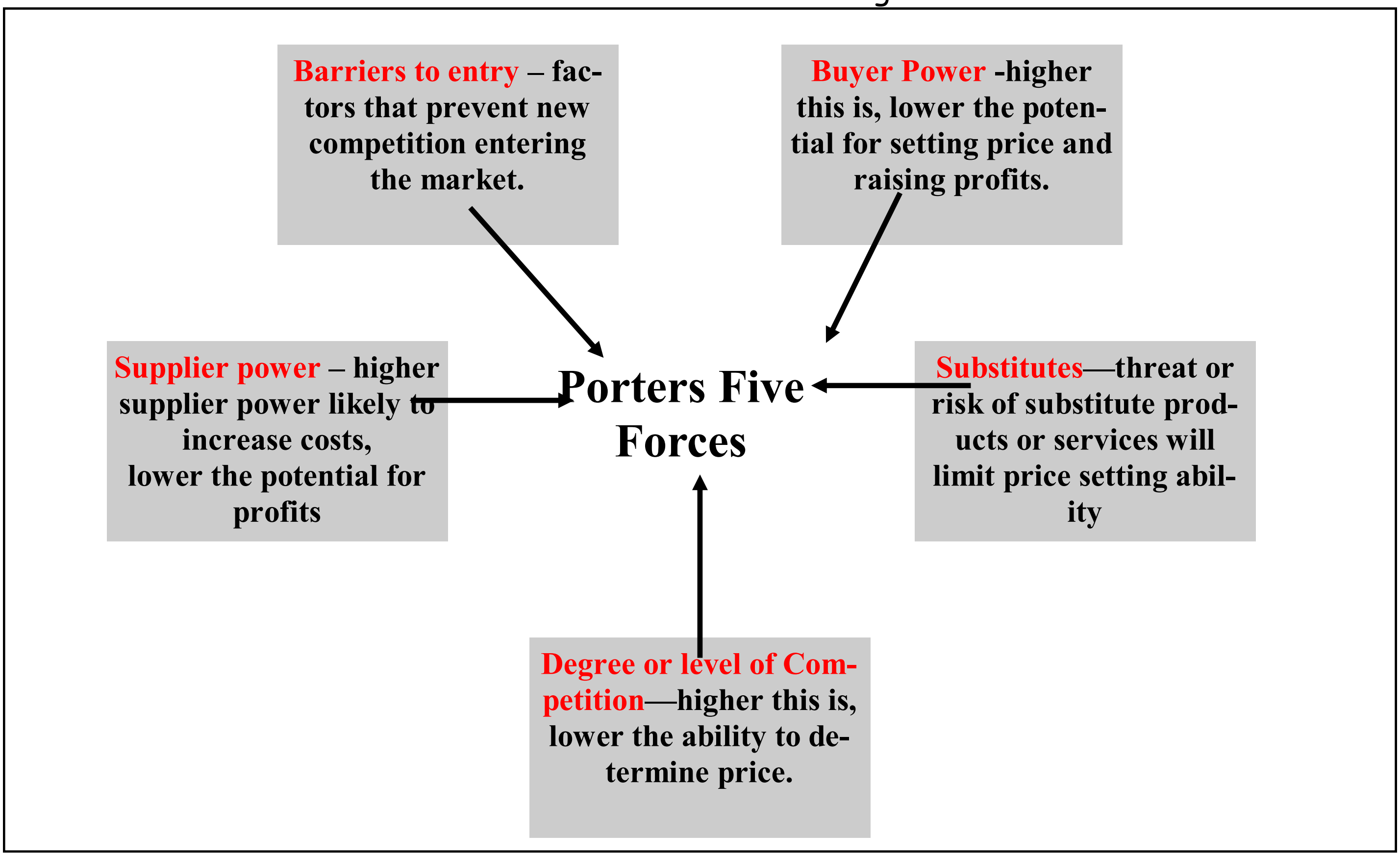
Porter proposed a model of the business environment that pictured industries and firms as being influenced by five forces. He put forward the idea that the interaction and influence of these 5 forces will determine the likely levels of profitability for a firm within a particular industry.

Business owners and managers can use this model of five forces, to better understand the industry in which the firm operates, and properly consider the external influences on the firms behaviour. Once they have this understanding managers will be able to devise appropriate strategies, showing how to maximise profitability. Understanding of the Porters Five forces will also demonstrate to owners and managers that there are limits on what can be achieved, and therefore how to set realistic objectives.

Force 1.

Barriers to Entry – factors that prevent new competition entering the market. If these are strong then monopoly profits can occur, weak then only normal profits can be earned. Examples include;

- Cost advantages of existing firms.
- Access to factors of production e.g. raw materials, skilled staff, and components.
- Government policy – govt. created monopolies, licensing, regulation.
- Economies of scale—these reduce average costs of production, making it difficult for new entrants to compete.
- High capital/ investment requirements.
- Strong Brand identity of existing firms products
- Access to distribution networks
- Predictable behaviour of existing firms e.g. retaliation through short term pricing strategies.



- Access to technologies used in the industry.

Force 2.

Supplier Power – higher the supplier power, the lower the potential for profits. If suppliers have high levels of power they are able to push up prices for raw materials and components, so lower profit margins for the buyer. On the other hand with lower levels of supplier power, the situation is reversed, the buyer may be able to force prices paid for components and raw materials down, so higher profit margins for the buyer. Examples of factors that determine supplier power include:

- The number of alternative suppliers—competition amongst suppliers.
- Importance of volume to supplier
- If inputs make up a large proportion of costs
- If inputs (raw materials or components) help create differentiation of product made.
- The costs of switching to a new supplier
- Availability of alternative (substitute) inputs

Force 3

Buyer Power— in this case we consider the influence of the end user of the product, the buyer. The higher the buyer power, lower the potential for setting price and increasing profits. But of course the lower the buyer power the more control the supplier firm has over price and profit margins, Examples of factors that determine buyer power include;

- The amount of bargaining leverage the buyer has. For example are the buyers the major distributor on the market?
- Buyer volume—are they buying in bulk? The larger the order the great the level of negotiated discount
- Whether the buyer has information on costs / availability of alternative suppliers.
- Brand identity and loyalty of the product bought. If the product is branded they buyer has less control over price paid, they may even be told the price that they can sell the product at.
- Price sensitivity of the product—how changes in price affect demand levels.
- Threat of take-over by customers.
- Availability of substitutes – can the buyer buy from elsewhere?

Force 4

Degree or level of Competition in the market. –the level of competition in a market can in theory vary between a pure monopoly to perfect competition. As a general rule we can say the lower the level of competition the higher the profit margins. Examples of factors that determine the numbers of competitors in a market include;

- The level of collusion in the market—do the firms act together to control price and share out the market between them?
- Maturity of the market—is the market stable with established brands and market leaders, or is the market immature, with new entrants being able to join.
- Industry concentration—is the market a monopoly, or an oligopoly with a few firms dominating the market, or even more like perfect competition with may firms having small market shares.
- Product differentiation in the market. Is the market full of virtually identical products (soap powders), or are the products identifiably different (car market).

- Strength of brands in the market, levels of brand loyalty. Are customers easily tempted to switch brands.
- The existence of patents and licenses to operate in the market. Patents can give companies monopolies of production of specific products, and licences offered by governments or regulators will limit the numbers of competitors.

Force 5.

Threat or risk of substitute products or services —when there is the possibility of buyers switching to an alternative product, then behaviour of the supplier firm will always take this in consideration. One reason why OPEC is not in favour of $150 dollar a barrel oil in the long run, is that this price level will encourage large scale investment into alterative sources of energy, and alternative products such as electrically powered cars. For a long period there was no risk of substitute products to fixed line phones and for terrestrial TV— but now we have mobiles, and satellite and cable TV.

- Examples of factors that determine the likelihood of availability of substitute products include:
- Rate of change of technology—fast the rate of change of technology, more quickly substitutes are likely to occur
- Availability of capital for investment—are potential producers of substitutes likely to be able to raise the capital required for R and D and production
- Switching costs for customers—cost of changing to substitute.
  Level of substitution effect—how close is the substitute, how easily does it replace the original product or service.
- Price-performance trade-off of substitutes—how effective are the substitutes cost and performance wise, for example at the moment electric cars do not offer an effective substitute for petrol engine cars so few people consider them as effective substitutes.

Notes