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# Essay: Five Forces framework

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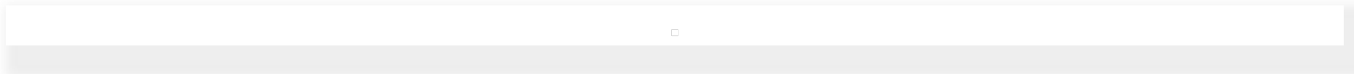

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The Five Forces framework is a “useful starting point for strategic analysis even where profit criteria may not apply” (Johnson, Scholes & Whittington, 2008, p. 60). It is critical to have prior knowledge of an industry before a strategy can be formed. Porter’s Five Forces outlines the forces that characterise the intense rivalry in an industry. These include: Power of Buyers, Power of Suppliers, Threat of New Entrants, and the intensity of rivalry itself (Porter, 1979).

The Power of Buyers can be determined by many different variables in an industry. When customers have a lot of power they “can force down prices, demand higher quality or more service, and play competitors off against each other-all at the expense of industry profits.” (Porter, 1979, p.140). In other words, when a

business deals with only a few savvy customers, the they have an upper hand, but as a company's customer base grows their power increases. Porter (1979) discusses how there are many ways that would make a buyer powerful, such as:

• The volume of the consumers purchase. The larger the purchase the more powerful the consumer. Buying in large volumes is more relevant in an industry which has high fixed costs.

• Similar products in the industry. Companies may compete on the price of the good but as it is much the same is becomes easy for a consumer to switch from one supplier to another. This leaves the power in the hands of the buyer.

• If the product purchased by the consumer only represents a small proportion of their income, they are less likely to be price sensitive. This gives consumers the ability to shop around to find, not only a product that is priced reasonably, but also one that is high in quality.

• If the condition of an industry's good affects the condition of a buyer's good then buyers are typically less price sensitive. Examples include large machinery in a factory. Failure of these machines could lead to huge loses.

• The good does not save the consumer money. If the good can make you more money than it cost a consumer is less price sensitive. This is common in accounting and investment banking.

• There is a high threat of backwards integration.

There are a few questions that can be asked for you to conclude if the buyer has power. How easy is it for buyers to drive down prices? How many buyers are there, and how big are their orders? How much would it cost them to switch from your products and services to those of a rival? Are your buyers strong enough to dictate terms to you?

The Power of Suppliers can be determined by many different variables in an industry. "Suppliers can exert bargaining power on participants in an industry by raising prices or reducing the quality of purchased goods and services. Powerful suppliers can thereby squeeze profitability out of an industry unable to recover cost increases in its own prices" (Porter, 1979, p.140). The more you have to choose from, the easier it will be to switch to a cheaper alternative. But the fewer suppliers there are, and the more you need their help, the stronger their position and their ability to charge you more. That can impact your profit. Porter (1979) discusses how there many ways that would make a supplier powerful, such as:

• It is controlled by a small number of businesses and is highly concentrated, more so than that of the industry to which it is selling.

• Differentiated products in the industry. A greater difference between products in the industry means a consumer will find the good that suits their needs and not transition from it as it will be unlikely to find something similar.

• Their ability to forward integrate. This shows an analysis of an industry's capability to better the terms of purchases.

• There is no importance of the supplier group. If there is an importance, the suppliers will reinvest in research and development and promote fair prices.

There are a few questions that can be asked for you to conclude if the supplier has power. How easy is it for your suppliers to increase their prices? How many potential suppliers do you have? How unique is the

product or service that they provide, and how expensive would it be to switch from one supplier to another?

“New entrants to an industry bring new capacity, the desire to gain market share, and often substantial resources...the seriousness of the threat of entry depends on the barriers present and on the reaction from existing competitors that the entrant can expect.” (Porter, 1979, p.138). If it takes little money and effort to enter your market and compete effectively, or if you have little protection for your key technologies, then rivals can quickly enter your market and weaken you position. If you have strong and durable barriers to entry, then you can preserve a favourable position and take fair advantage of it. Porter (1979) discusses the sources of barriers to entry:

• Economies of Scale-This discourages entry as the entrant would have to infiltrate the industry on a large scale or may not be able to offer the consumers the value of their competition. The economies of scale can hinder financing, distribution and many other parts of a company.

• Product differentiation-Barriers may be created when entrants are forced to spend large amounts of their investment in brand awareness and conquering brand loyalty. There are many factors that influence brand identification, such as, product differences, customer service, advertising and the length of time the business has been around.

• Capital requirements-When entering an industry barriers to entry may be created by high expenses such as advertising, and research and development. Capital is required to overcome losses when the business is first set up. Without the heavy capital need to set up a business it becomes hard for a start-up company to compete with large multinational corporations.

• Cost disadvantages independent of size-Some businesses may have advantages over others, no matter the size of the competing company. These may come from government subsidies, better access to raw materials, better knowledge of the industry, or a superior location.

• Access to distribution channels-It may be difficult for a new entrant to find a channel of distribution for their product. It is necessary for them to have promotions and price breaks if they want their product to be initially popular. The greater the hold of the existing competition, the harder it is to enter into the industry.

• Government policy-It is legally required for some industries to follow the rules of the government. The government can do such things as enforce license requirements and put a cap on the access to raw materials. Their controls affect barriers to entry in a major way.

There are a few questions that can be asked for you to conclude if there are high threat of new entrants. Can your position be affected by people’s ability to enter your market? So, think about how easily this could be done. How easy is it to get a foothold in your industry or market? How much would it cost, and how tightly is your sector regulated?

The Threat of Substitution refers to the likelihood of your customers finding a different way of doing what you do. For example, if you supple a unique software product that automates an important process, people may substitute it by doing the process manually or by outsourcing it. A substitution that is easy and cheap to make can weaken your position and threaten your profitability. “By placing a ceiling on prices it can charge, substitute products and services limit the potential of an industry.” (Porter, 1979, p.142). Porter (1979) discusses the reasons for substitution:

• Switching Costs-A consumer is more likely to move to a more attractive substitute if there are little switching costs. Without differentiation or brand loyalty it will not be difficult to choose between switching products.

• Product Price-Consumers are more likely to switch products if their substitute is priced more reasonably. If a company was to increase their price higher than that of its substitutes it may lead to consumers converting from the original product.

• Product Quality-If the substitute good is better quality than the other products on the market, it is more likely that a consumer will switch to the substitute option.

• Product Performance-If the substitute product performs at a higher standard than other goods then a consumer will swap to that substitute.

There are a few questions that can be asked for you to conclude the threat of substitutes. What are benefits that your product doesn't provide but the alternate does? What are the price points and how do they differ? Can prices change suddenly? Are there any weak points in the substitute item? Are there any limitations to its use? Are there any barriers that may stop a consumer from switching? Are there any trends that define the substitute products industry? What aspects are responsible for value to the consumer?

"Rivalry among existing competitors takes the familiar form of jockeying for position" (Porter, 1979, p.142) Where Rivalry is intense, companies can attract customers with aggressive price cuts and high-impact marketing campaigns. Also, in markets with lots of rivals, your suppliers and buyers can go elsewhere if they feel that they're not getting a good deal from you. On the other hand, where competitive rivalry is minimal, and no one else is doing what you do, then you'll likely have tremendous strength and healthy profits. Porter (1979) discusses the factors related to intense rivalry:

• The presence of many competitors that are at the same stage of business, are the same size and have relatively the same amount of power.

• Advancement of an industry is lacking.

• There is an absence of differentiation between products. Having differentiation would give the business the ability to attract buyers who wouldn't find the same good anywhere else.

• If a product has a short shelf life or high fixed costs there is an appeal of cutting prices. Where materials such as paper are involved a business may struggle through this problem when demand is low.

• There are high exit barriers. These exit barriers keep competition in an industry high, even if these business end up recording losses because of their intense competition. Government help may be needed to prevent the industry from being over capacitated.

• Rivals in the industry have different approaches in their strategies and ideas of how to compete with each other in the long run.

There are a few questions that can be asked for you to estimate the intensity of rivalry in an industry. How many rivals do you have? Who are they, and how does the quality of their products and services compare with yours?

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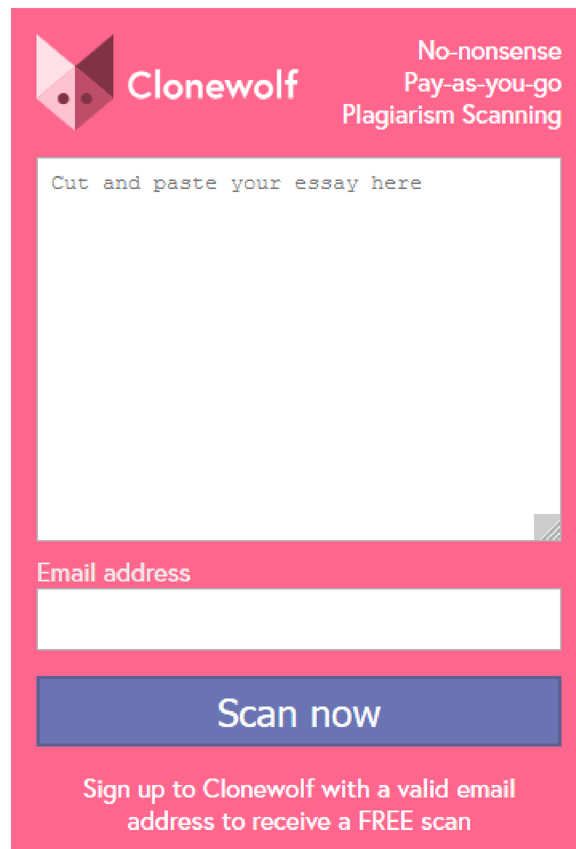



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