Tools and Techniques feature: How to undertake an analysis of Porter’s five forces

The five forces framework is undertaken from the perspective of an incumbent organization, i.e. an organization already operating in the industry. The analysis is best used at the level of an organization’s strategic business unit (SBU). Although each organization in an industry is unique, the forces within the industry which affect its performance, and hence its profitability, will be common to all organizations in the industry. It is in this sense that Porter’s contribution is pervasive—the ability to generalize these five forces to all organizations within the industry. Although the five forces analysis is undertaken from the perspective of an incumbent firm, it can be used to determine whether a firm outside an industry should enter the industry. In this case the barriers to entry which may be protecting the incumbents is an additional cost that outsiders must factor into their analysis of whether to enter the industry. An organization thinking of entering an industry will need to know that it can success-fully compete with incumbents in the industry. This will require it to adopt a distinctive positioning. For example, Amazon effectively entered book retailing by utilizing the Internet to create support activities which provide a sustainable competitive advantage.

The five forces framework is an analytical tool for assessing the competitive environment (see Porter (1980, Chapter 1) for a discussion of the structural analysis of industries). It enables an organization to determine the attractiveness or profit potential of a particular industry by examining the interaction of five competitive forces. It is the combined strength of these five forces which will ultimately determine an organization’s return on investment or the potential for profits within a given industry. The five forces are (1) threat of new entrants, (2) bargaining power of buyers, (3) bargaining power of suppliers, (4) threat of substitute products or services, and (5) intensity of rivalry among firms in an industry. By examining all five competitive forces an organization is able to assess its ability to compete effectively in an industry. The five forces framework is based on an economic theory known as the ‘structure–conduct–performance’ (SCP) model. This states that the structure of an industry determines an organization’s competitive behaviour (conduct), which in turn determines its profitability (performance).

The five forces framework is a rigorous approach to looking at industries and where organizations stand in relation to their industry. In this respect it differs from SWOT analysis which is company specific, while Porter’s five forces framework is industry specific. The five forces framework allows an organization to make informed decisions, given its resources, about whether competitive rivalry, bargaining power of suppliers, bargaining power of buyers, threat of new
entrants, and threat of substitutes make this industry an attractive (profitable) one to compete in.

Using Porter’s five forces, an incumbent organization can, for example, decide that industry conditions suggest that it would be more beneficial to use its resources and capabilities in an alternative industry, i.e. it should exit the industry or at least decrease its resource commitment to that industry. The five forces framework also enables an organization to improve its competitive positive in relation to industry trends. For example, an awareness of a trend towards consolidation among suppliers (leading to an increase in supplier power) might lead an organization to strengthen its relationships with its existing supplier to avoid downward pressures on its profit margins. Therefore accurately estimating future trends in the five forces should also provide an organization with an indication of future profits in the industry.

For Porter the level of competition within an industry is determined by its underlying structure. Therefore if an organisation understands the forces that make up that structure it should be able to take action to influence or mitigate their effects. The role of the manager then is to ascertain which of these five forces are likely to have the greatest impact on the organisation and how might strategic decision making be used to influence them. For example, an organisation might be concerned about how easy it is for new firms to enter the industry. This is because, other things being equal, entry barriers are required to ensure above-average profits.
Managers can use the diagram below or place these five forces in a table using + (positive sign) to indicate a comparative strength against the five forces and – (negative sign) to indicate a comparative weakness.

**Threat of New Entrants**
- capital requirements
- product differentiation
- switching costs
- threat of retaliation
- access to distribution channels

**Power of Suppliers**
- buyer concentration
- brand reputation
- availability of substitutes
- relationships with customers
- threat of backward integration

**Competitive Rivalry**
- number and size of competitors
- industry growth rate
- high fixed costs
- high exit barriers
- lack of differentiation

**Availability of Substitute Products and Services**
- price/performance ratio of substitute products and services

**Power of Buyers**
- buyer concentration
- volumes purchased
- undifferentiated product
- switching cost
- product/service importance
- threat of backward integration
What an organization might do therefore is list the main barriers to entry as:
economies of scale, capital requirements, product differentiation, access to
distribution channels, cost advantages independent of size, and switching costs.
Having ascertained the importance of each of these factors for their particular
industry managers can then weigh their relative strengths against each of these
factors. In addition, managers may want to customise these factors to more
clearly represent the factors in their industry. A manager might therefore use a
simple rating system such as + (positive sign) and - (negative sign) to
demonstrate whether it is positioned against these factors in a positive or
negative way. For example if product differentiation is known to be a key success
factor in this particular industry and the organization is a market leader in product
development and innovation we would expect it to have a + against this factor. If
the organization has been a follower rather than a leader in product differentiation
it might score itself with a minus sign. Of course, managers in an organization
can choose to make the rating system as simple or complex as they desire. All
this information is then captured and output in tabular or graphical form for
comparative analysis. The key thing to bear in mind is that the scores provided
by the rating system will change as markets change and evolve over time. Also,
an organization’s score against these factors will also change as its resources
and capabilities change over time.

By undertaking this same analysis for each of the five forces and the factors that
determine these five forces an organization is able to build up a complete picture
of the effects that the five forces has on the industries in which the organization
competes organization. At the same time, where it is at a relative disadvantage to
other organizations it can use its analysis of the strengths and weaknesses of its
position in reference to the five forces to help it determine which resources and
capabilities it needs to build up in order to compete successfully and achieve a
competitive advantage. Of course, the analysis of each of the five forces can be
subdivided to reach an irreducible minimum that more clearly represents the
industry being considered.

Some might argue that Porter’s five forces are a little static and therefore difficult
to help managers take account of the evolution in an industry. However, if we use
strategic group analysis to help determine what is happening in an industry, for
example, consolidation and we chart the direction in which competitors in a
particular strategic group are moving this can go some way to providing Porter’s
five forces framework with a greater dynamic. Perhaps a more important criticism
is that Porter assumes competition within is based on a zero sum game. In other
words suppliers and buyers are to be seen as a threat, as indeed are other
incumbents within the industry. In fact, strategic alliances and cooperation among
competitors even in the same industry can be mutually beneficial. If we look at
the relationship between Microsoft and Intel it becomes apparent this is not one
of customers and supplier one of complementor. That is, the microprocessors
provided by Intel allow the software provided by Microsoft to run more quickly and efficiently. In effect without Intel's innovative processes Microsoft's frequently upgraded software would be less valuable to the consumer. At the same time, without Microsoft's upgraded products which require faster processor speeds they would be less reason to buy Intel's improved processes.

Clearly, as an organization more fully understands the determinants of Porter's five forces and which particular forces have the greatest impact on its market position it is in a stronger position to defend itself against potential threats and to influence these forces with its strategic decision-making. Markets are dynamic and in a constant state of flux. Therefore it is necessary to monitor and evaluate how these structural forces change over time. The best use of Porter's five forces arguably is not to erect barriers but rather to use this analysis to guide the building up of competences and capabilities.

References:
