

## Five Forces Analysis

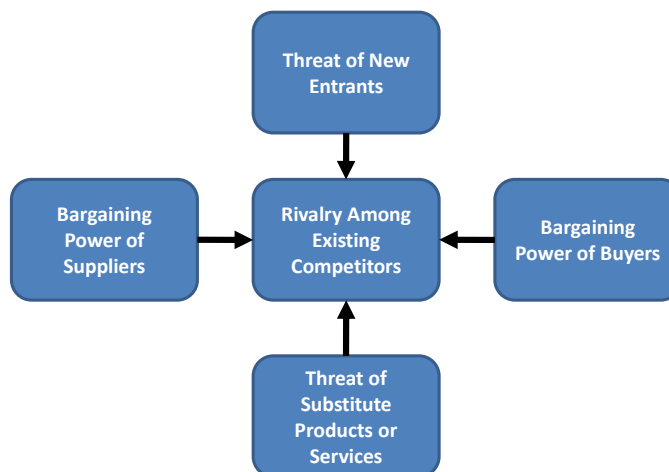
### Key Points:

- After 30 years, the Five Forces Analysis is still one of the most effective ways to assess industry structure and performance when done correctly.
- As the tool's name states, there are five forces that together illuminate industry structure: Bargaining Power of Buyers, Bargaining Power of Suppliers, Barriers to Entry, Threat of Substitute Product or Services, and Rivalry Among Existing Competitors.
- A recent update to the model is the addition of Complements, goods or services that impact the demand of the products/services provided by the industry under analysis. It is considered more of a factor than a force per the model creator.

### Main Thoughts:

Where the PESTEL analysis is a general or macro environmental analysis tool, the Five Forces model is a means to assess the micro or industry environment. Developed by strategy professor Michael Porter of Harvard Business School in the early 1970s, the Five Forces model has become one of the most widely known strategy analysis tools in use today. The tool helps users identify—through detailed examination of each force—what the underlying drivers of industry behavior and performance are.

**Figure 1: The Five Forces Model**



*Bargaining Power of Buyers.* Buyers are the customers or the purchasers of products or services within an industry. Buyers typically seek to maximize their value by purchasing at the lowest possible costs. The more power buyers have over the industry participants, the more effective they are in their quest to drive down process (and profits for the industry). As a group, buyers wield power over an industry when:

- There are few of them;
- They purchase a large amount of total output from the industry;
- Products or services they purchase are homogenous and undifferentiated;
- Switching costs from one product or service to another are low;
- There is a realistic threat they could backward integrate into the industry itself.

Firms that provide basic house wares like paint brushes for instance are affected by the tremendous power of retail buyers like Wal-Mart and Target. Big box retailers are few in number, buy huge quantities of industry output of an essentially undifferentiated product with no switching costs. Thus they exert great power on house ware producers.

*Bargaining Power of Suppliers.* Suppliers provide inputs to the industry that are used in creating the product or delivering the serve. Like buyers, suppliers are seeking to maximize their return by charging as much as they can for their inputs or reducing the quality of those inputs. As is the case with buyers, the more power suppliers have over an industry, the more effectively they will maximize their own profitability at the expense of the industries participants. As a group, buyers have power when:

- There are few of them;
- They provide a large amount of total input to the industry;
- Their inputs are critical to the industry;
- They have created high switching costs of the industry;
- The industry is a small portion of their total output;
- There is a realistic threat they can forward integrate into the industry itself.

The commercial airline industry has very powerful suppliers. As an example, there are only a handful of engine manufacturers that provide virtually all of a critical input to the industry from which airlines have a difficult time switching away from.

*Threat of Substitutes.* Substitutes are products or services that offer essentially the same function as those produced by the industry however they are outside the industry boundaries. As an example, a substitute for a soft drink is water or coffee, something that is outside of the soft drink industry. Threats from substitute goods or services are high when:

- The price/performance characteristics of the substitute are comparable to those provided by the industry;
- Switching costs to the substitute are low.

Compact discs which were the dominant form of music distribution into the new millennium are being replaced by digital music that can be stored and played on computers and other portable devices.

*Threat of New Entrants.* In industries where returns to existing participants are favorable, the desire to enter the industry is high. Increased competition unfortunately has two unfavorable effects on performance. First, additional capacity is added that many times is not offset by increased demand. Second, new entrants may try to gain share with price-based competition. Both of these factors place pressures on pricing, force more vigorous investment and cost containment, all the while hurting profitability. This threat of entry into an industry is a function of two things:

- Height of barriers to entry and;
- Likelihood of retaliation by existing competitors.

For example, the rising online bookseller Amazon.com has contributed to the growth of the self published book movement now that anyone can list and distribute a book on Amazon. This has placed increased pressure on the traditional book publishing industry

at a time when it is also faced with increased competition from substitutes such as e-books.

*Rivalry Among Existing Competitors.* The rivalry among existing competitors pertains to the intensity and basis of competition within the industry. The rivalry is intense when:

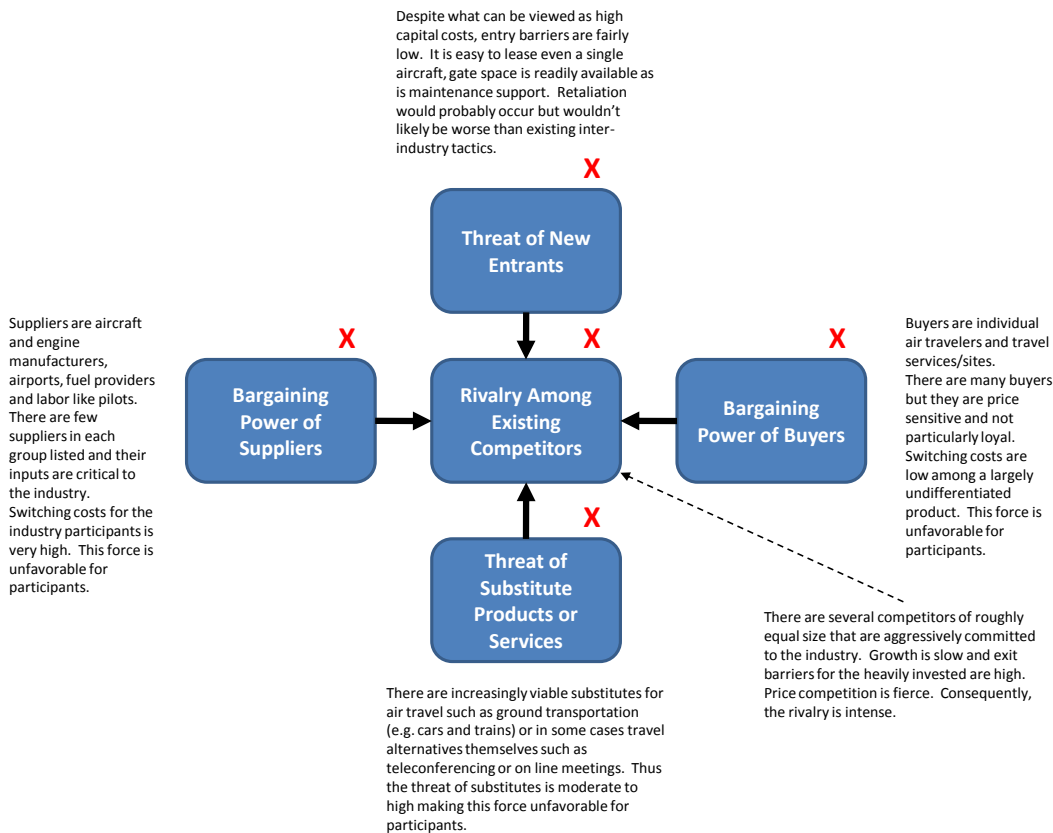
- There are many competitors of roughly equal size;
- The industry has slow or no growth;
- Exit barriers are high;
- Existing firms are committed to staying in the industry;
- There are few bases of competition beyond price.

Again, the commercial airline industry is an example of an industry plagued by low profitability as a function of numerous competitors, slow growth, high commitment to staying in the industry and rampant price competition.

**As an Example:**

Here is an example of a partially completed five forces analysis for the commercial airline industry. Each force is assessed qualitatively using the bulleted points above. The red "X" in each force indicates that it is unfavorable for participants within the industry.

**Figure 2: The Five Forces Model for the Commercial Airline industry**



**Editorial**

The five forces model has withstood the test of time for a simple reason: it's very effective. It's effective in that it helps link industry structure with returns as well as helps

uncover why firms in the industry compete as they do. There are a few important points to keep in mind when performing the analysis.

First, the point of view is from inside the industry. Second, the industry itself must be correctly defined. Often managers err on the side of too narrow a definition which limits the effectiveness of the analysis. Next, it's important to identify each of the specific actors or elements comprising each force (e.g. who are the customer groups and who are the major suppliers?). Then consider the drivers of each force and evaluate not only their present strength but how they will change over time. Lastly remember that the five forces analysis links to industry returns (that's the point of the analysis to begin with) so be sure to look at the analysis in conjunction with actual industry profit to see if they're consistent.

**For More Information See:**Web

Harvard Business Interview with Michael Porter:

[http://www.youtube.com/watch?v=mYF2\\_FBCvXw&feature=related](http://www.youtube.com/watch?v=mYF2_FBCvXw&feature=related)

Magazines & Journals

Porter, M.E., *The Five Forces That Shape Competition*, Harvard Business Review, January, 2008

Books

Porter, Michael E. (1980). *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press.