Competitive Environment - Five Forces
Porter’s Five Forces

- Devised by Michael Porter
- A framework for analysing the nature of competition within an industry
Every industry is different

- Size
- Structure
- Distribution channels
- Customer needs and wants
- Profitability
- Growth
- Product life cycle
- Alternatives for the consumer

Which means industry profits are different too.
Why do industry profits vary so much?

**Airlines**
- Low Profits

**Soft Drinks**
- High Profits
Why do airlines make so little profit (and such big losses)?

• Very intensive competitor rivalry – mainly on price
• Low barriers to entry – lots of new airlines who want to set up
• Suppliers of aircraft & equipment are powerful – can charge high margins
• Customers have lots of substitute options – e.g. rail, car
Why are profits so high in the soft drinks market?

• A “licence to print money”
• Customers and suppliers have little power
• High brand awareness & loyalty = less desire for substitutes
• High barriers to entry
Summary for industry profits

High industry profits associated with:
- Weak suppliers
- Weak customers (buyers)
- High entry barriers
- Few opportunities for substitutes
- Little rivalry

Low industry profits associated with:
- Strong suppliers
- Strong customers (buyers)
- Low entry barriers
- Many opportunities for substitutes
- Intense rivalry
The five forces

• Threat of new entrants to a market
• Bargaining power of suppliers
• Bargaining power of customers ("buyers")
• Threat of substitute products
• Degree of competitive rivalry
The five forces framework

Intensity of rivalry within the industry

Threat of Substitute Products

Threat of New Entrants

Bargaining Power of Suppliers

Bargaining Power of Buyers (Customers)
Threat of new entrants

- If new entrants move into an industry they will gain market share & rivalry will intensify.
- The position of existing firms is stronger if there are barriers to entering the market.
- If barriers to entry are low then the threat of new entrants will be high, and vice versa.
Barriers to entry (1)

• **Investment cost**
  – High cost will deter entry
  – High capital requirements might mean that only large businesses can compete

• **Economies of scale available to existing firms**
  – Lower unit costs make it difficult for smaller newcomers to break into the market and compete effectively

• **Regulatory and legal restrictions**
  – Each restriction can act as a barrier to entry
  – E.g. patents provide the patent holder with protection, at least in the short run
Barriers to entry (2)

• **Product differentiation (including brands)**
  – Existing products with strong USP’s and/or brand increase customer loyalty and make it difficult for newcomers to gain market share

• **Access to suppliers and distribution channels**
  – A lack of access will make it difficult for newcomers to enter the market

• **Retaliation by established products**
  – E.g. the threat of *price war* will act to discourage new entrants
  – But competition law outlaws actions like *predatory pricing*
Factors determining the threat of new entrants

- Cost advantages
- Access to inputs
- Government policy
- Economies of scale
- Capital requirements
- Brand recognition & loyalty
- Access to distribution
- Expected retaliation
- Proprietary products
Easy or difficult entry?

Easy to enter if there is

• Common technology
• Access to distribution channels
• Low capital requirements
• No need to have high capacity and output
• Absence of strong brands and customer loyalty

Difficult to enter if there is

• Patented or proprietary know-how
• Well-established brands
• Restricted distribution channels
• High capital requirements
• Need to achieve economies of scale for acceptable unit costs
Bargaining power of suppliers

- If a firm’s suppliers have bargaining power they will:
  - Exercise that power
  - Sell their products at a higher price
  - Squeeze industry profits
- If the supplier forces up the price paid for inputs, profits will be reduced
- The more powerful the customer (buyer) the lower the price
Determinants of supplier power

• Uniqueness of the input supplied
  – If the resource is essential to the buying firm and no close substitutes are available, suppliers are in a powerful position

• Number and size of firms supplying the resources
  – A few large suppliers can exert more power over market prices that many smaller suppliers each with a small market share

• Competition for the input from other industries
  – If there is great competition, the supplier will be in a stronger position

• Cost of switching to alternative sources
Suppliers are powerful when

- There are only a few large suppliers
- The resource they supply is scarce
- The cost of switching to an alternative supplier is high
- The product is easy to distinguish and loyal customers are reluctant to switch
- The supplier can threaten to integrate vertically
- The customer is small and unimportant
- There are no or few substitute resources available
The power of customers

• Powerful customers are able to exert pressure to drive down prices
• E.g. supermarket business is increasingly dominated by a small number of large retail chains able exert great power over supply firms
Customer power in action?

OFT steps up inquiry into allegations that supermarkets bully suppliers over prices

By Susie Mesure
Saturday, 22 February 2004

The UK's top competition watchdog stepped up its investigation yesterday

OFT accuses recruitment firms of price fixing

21 October, 2009 | By Nick Whitten

Eight construction recruitment agencies have been accused of price fixing by the Office of Fair Trading.

'Prevent raw deal for supermarket suppliers', government urged

Simeon Goldstein, packagingnews.co.uk, 06 August 2009

The Competition Commission has called on the government to set up a groceries market ombudsman to prevent suppliers getting a raw deal, after talks with retailers broke down.

In a letter to the Department of Business, Innovation and Skills, the chairman of the groceries market enquiry, Peter Freeman said progress had been made on enhancing the code of practice.

But negotiations have reached an impasse over setting up an ombudsman. The "big four" retailers — Asda, Morrisons, Sainsbury's and Tesco — all oppose it. Marks and Spencer and Waitrose back the idea.

Freeman said the government needed to set up an ombudsman as soon as possible. "The new code of practice will work better as a result and suppliers and retailers will have greater confidence its terms will be observed," he said.

But there are concerns that no action will be taken until after a general election and the Office of Fair Trading, which referred the case, believes it would take on the
Determinants of customer power

- Number of customers
  - The smaller the number of customers, the greater their power

- Volume of their order sizes
  - The larger the volume the greater, the bargaining power of customers

- Number of firms supplying the product
  - The smaller the number of suppliers, the less opportunity customers have for shopping around

- The threat of integrating backwards- if customers pose a threat of integrating backwards they will enjoy increased power

- The cost of switching
Customers are strong if...

- There are only a few of them
- If the customer purchases a significant proportion of output of an industry
- They possess a credible backward integration threat – that is they threaten to buy the producing firm or its rivals
- If they can choose from a wide range of supply firms
- If they find it easy and inexpensive to switch to alternative suppliers
Threat of substitute products

• A substitute product can be regarded as something that meets the same need
• Substitute products are produced in a different industry – but crucially satisfy the same customer need
• If there are substitutes to a firm’s product, they will limit the price that can be charged and will reduce profits
Substitutes for newspapers
The threat of substitutes

• The extent of the threat depends upon
  – The extent to which the price and performance of the substitute can match the industry’s product
  – The willingness of customers to switch
  – Customer loyalty and switching costs

• If there is a threat from a rival product the firm will have to improve the performance of their products by reducing costs and therefore prices and by differentiation
Degree of competitive rivalry

• If there is intense rivalry in an industry, it will encourage businesses to engage in
  – Price wars (competitive price reductions),
  – Investment in innovation & new products
  – Intensely promotion (sales promotion and higher spending on advertising)

• All these are likely to increase costs and lower profits
Determinants of intensity of rivalry (1)

- **Number of competitors in the market**
  - Competitive rivalry will be higher in an industry with many current and potential competitors

- **Market size and growth prospects**
  - Competition is always most intense in stagnating markets

- **Product differentiation and brand loyalty**
  - The greater the customer loyalty the less intense the competition
  - The lower the degree of product differentiation the greater the intensity of price competition
Determinants of intensity of rivalry (2)

• The power of buyers and the availability of substitutes
  – If buyers are strong and/or if close substitutes are available, there will be more intense competitive rivalry

• Capacity utilisation
  – The existence of spare capacity will increase the intensity of competition

• The cost structure of the industry
  – Where fixed costs are a high percentage of costs then profits will be very dependent on volume
  – As a result there will be intense competition over market shares

• Exit barriers
  – If it is difficult or expensive to exit an industry, firms will remain thus adding to the intensity of competition
Michael Porter Explains All

The Five Competitive Forces That Shape Strategy

http://www.tutor2u.net/blog/index.php/business-studies/comments/porters-five-forces-explained-by-the-man-himself/
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