Porter's Five Forces

Strategy Skills

Team FME

www.free-management-ebooks.com

ISBN 978-1-62620-999-2

Copyright Notice

© **www.free-management-ebooks.com** 2013. All Rights Reserved

ISBN 978-1-62620-999-2

The material contained within this electronic publication is protected under International and Federal Copyright Laws and treaties, and as such any unauthorized reprint or use of this material is strictly prohibited.

You may not copy, forward, or transfer this publication or any part of it, whether in electronic or printed form, to another person, or entity.

Reproduction or translation of any part of this work without the permission of the copyright holder is against the law.

Your downloading and use of this eBook requires, and is an indication of, your complete acceptance of these 'Terms of Use.'

You do not have any right to resell or give away part,
or the whole, of this eBook.

Table of Contents

Preface 2

Visit Our Website 3

Introduction 4

Porter's Five Forces Analysis 6

Competitive Rivalry 11

Threat of New Entrants 18

Threat of Substitutes 20

Bargaining Power of Suppliers 23

Bargaining Power of Customers 25

Summary 28

Other Free Resources 30

References 31

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

Preface

This eBook describes Porter's Five Forces Framework, a technique that provides a model for industry analysis and business strategy development.

You will learn:

- The five key factors the model uses to identify and evaluate potential opportunities and risks
- The importance of defining your market accurately and how this can affect the usefulness of the results you obtain
- How to measure competitive rivalry using the Concentration Ratio and the Herfindahl–Hirschman Index
- How the availability of close substitute products can make an industry more competitive and decrease profit potential for the firms in the industry
- The limitations of this model, which was developed in an environment quite different to the one organizations find themselves operating in today

Visit Our Website

More free management eBooks along with a series of essential templates and checklists for managers are all available to download free of charge to your computer, iPad, or Amazon Kindle.

We are adding new titles every month, so don't forget to check our website regularly for the latest releases.

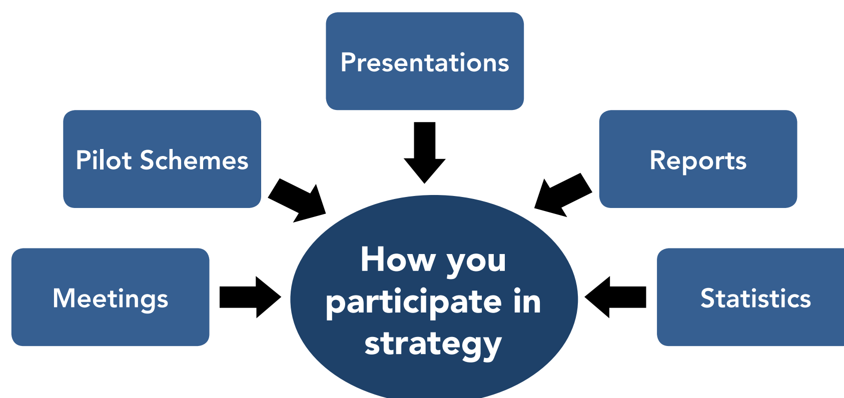
Visit **http://www.free-management-ebooks.com**

Introduction

Today's organizations find themselves operating in an environment that is changing faster than ever before. The process of analyzing the implications of these changes and modifying the way that the organization reacts to them is known as business strategy.

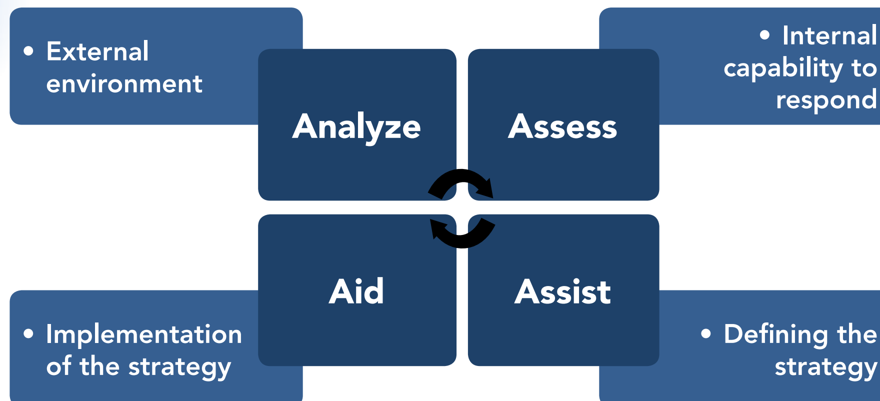
> ***'Strategy is the direction and scope of an organization over the long term, which achieves advantage in a changing environment through its configuration of resources and competences' Johnson et al. (2009).***

While your role as a manager is unlikely to require you to make decisions at the strategic level, you may be asked to contribute your expertise to meetings where strategic concerns are being discussed. You may also be asked to comment on pilot schemes, presentations, reports, or statistics that will affect future strategy.



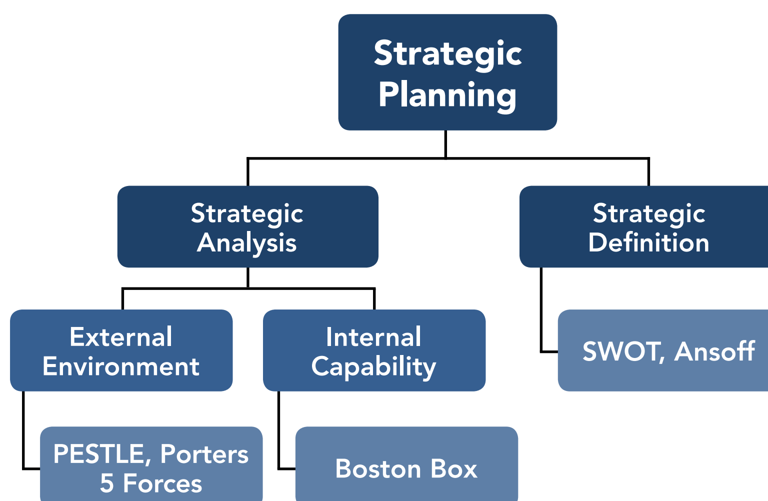
Whether you work in a large multinational corporation or a small organization, a good understanding of the appropriate business analysis techniques and terminology will help you to contribute to the strategic decision-making processes.

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com



Typical scenarios where you could be asked to provide information and data for your organization's strategic decision making include:

- Analyzing the organization's external environment.
- Assessing the organization's internal capabilities and how well it can respond to external forces.
- Assisting with the definition of the organization's strategy.
- Aiding in the implementation of the organization's strategy.



The diagram above shows where five widely used business analysis tools fit into the strategic planning process. This series of eBooks will give you a solid understanding of how these tools can be used, as well as an appreciation of their limitations.

This knowledge will enable you to take an active and productive role when asked to participate in the strategic decision-making process.

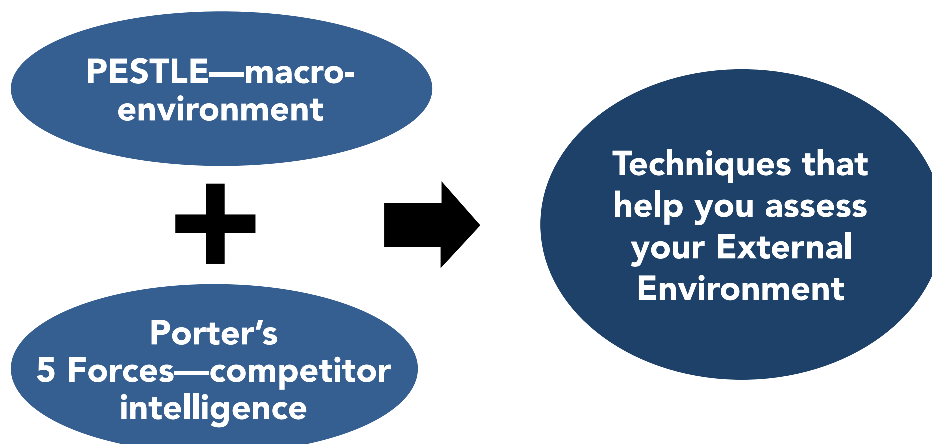
KEY POINTS

- ✔ You may be asked to contribute your expertise to meetings where strategic concerns are being discussed.
- ✔ Typical scenarios where you could be asked to provide information for strategic decision making include: analyzing the organization's external environment, assessing internal capabilities, assisting strategy definitions, and aiding in the implementation.

Porter's Five Forces Analysis

Any organizational strategy that you develop needs to include gaining a thorough understanding of the external environment that the organization is operating in. The two most widely used tools that can help you to do this are the PESTLE Analysis and Porter's Five Forces Analysis.

The PESTLE Analysis enables you to create a list of the potential issues within your macro-environment that have or could have implications for your organization. If you are unfamiliar with this analysis technique or want to understand it in greater detail then visit our website www.free-management-ebooks and download our free 'PESTLE Analysis' business strategy eBook.



ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

Whilst understanding the macro-environment is essential for developing your strategy it only gives you half of the picture. You also need to have a thorough understanding of your competitors and the impact they can have on your organization. To gain this knowledge you need to conduct Porter's Five Forces Analysis.

In 1979 Michael E. Porter of Harvard Business School identified five key forces that determined the fundamental attractiveness of a market or a market sector in the long term.

This became known as Porter's Five Forces Analysis and it provides a model that enables organizations to analyze their industry in a way that takes your competitors' activities into account. This is a vital part of creating a strategy, and it is important that managers understand how it works and how to contribute to it.

One of the most crucial aspects of using this technique is your organization's ability to define its market properly. Defining your market too narrowly, known as 'marketing myopia,' can make it impossible to work out who your competitors are in terms of market need and opportunities.

An example frequently quoted by marketing professionals is that of Coca-Cola:

> ***Coca-Cola defined its market and therefore its competitors as being in the 'soft drinks' market. This definition was too narrow and was not based on the needs of their customers; more realistically the market should have been described as 'social and snack-time' drinks.***
>
> ***If Coca-Cola had defined it as such then the company would have been better prepared for the impact coffee bars (Starbuck's, Costa Coffee, etc.) and the fresh fruit juice bars (Juice Stop, Juice Fix, Froot Smoothies, etc.) would have on its business.***

Porter's analysis technique has become popular with business and strategy analysts and is often regarded as a credible and more practical alternative to the widely used SWOT Analysis. This is because it looks at the forces your competitors can exert on your market and how this could affect your organization and its long-term success.

If you are unfamiliar with the SWOT Analysis technique or want to understand it in greater detail then visit our website www.free-management-ebooks.com and download our free 'SWOT Analysis' eBook.

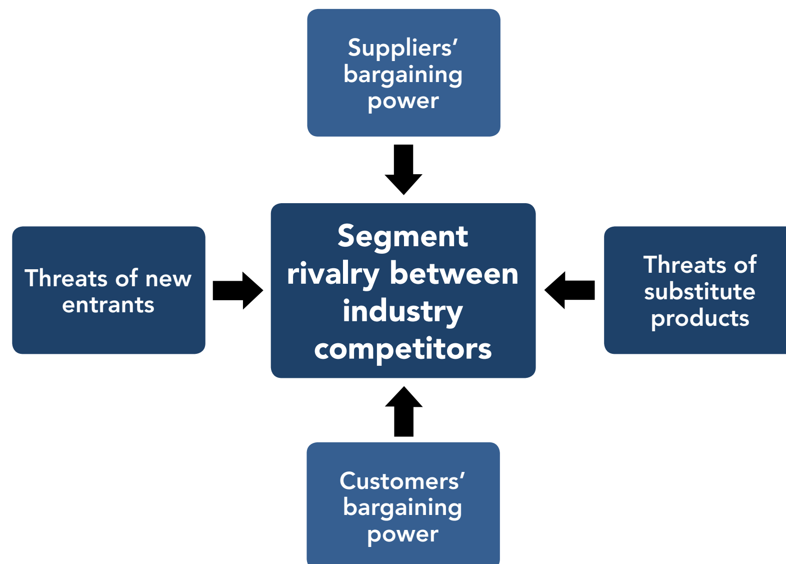
In today's highly competitive markets any successful organization will have a reasonable level of intelligence on its known competitors. But as recent events have shown, the greatest harm to your organization is unlikely to come from this quarter. Your greatest threats are more likely to come from new and emerging competitors or new technologies.

For example,

> ***New Entrant****—Consultancy services supplier Tata was a new entrant from India and has been able to make serious inroads into the market. Existing suppliers such as EDS and Accenture have struggled to retain their market share since Tata's arrival.*
>
> ***New Technology****—the success of eBook readers such as Kindle have found the publishing industry struggling to respond. A recent article in trade magazine Publishers Weekly stated that eBooks accounted for around a third of all book spending.*

Porter's model considers five forces that determine the 'attractiveness' of your market by analyzing the competitive intensity. What he meant by a particular market being 'attractive' was its overall industry profitability, which was assessed by looking at potential opportunities and risks.

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

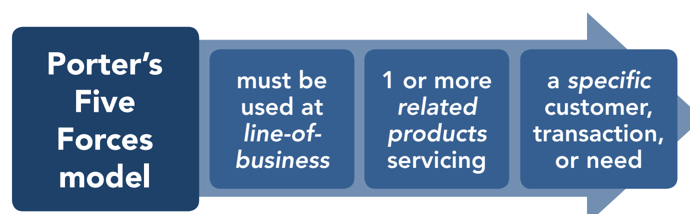


The five key factors the model uses to identify and evaluate potential opportunities and risks are:

- Competitive Rivalry
- Threat of New Entrants
- Threat of Substitutes
- Bargaining Power of Suppliers
- Bargaining Power of Customers

The first three are considered to be 'horizontal' competition (shown as dark blue in the diagram) because each force is operating in the same way within the market. The remaining two forces are classified as 'vertical' competition (light blue) because they operate within the supply chain.

It is important to remember when using Porter's Five Forces as part of your strategic analysis that the method was designed for use at the line-of-business level. 'Line-of-business' is defined as applying to a set of one or more highly related products that service a particular customer transaction or business need.



ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

If your organization has a diverse portfolio of products and services, then it must create a separate model for each of these areas. Understanding the dynamics of Porter's model is vital to successfully making informed decisions as part of your strategy process and you need to remember that it is not appropriate to use at the overall business level.

If an electrical retailer, for instance, had a large portfolio of products, they would need to develop separate Five Forces models for each range. For example:

- White goods (fridges, freezers, dishwashers, etc.)
- Small kitchen appliances
- Mobile phones
- Computers, laptops, and printers
- Camera equipment
- Television and home cinema

Each product range is quite separate from the others and the five factors affecting each one are quite specific. It is only by performing a separate analysis for each range that you will gain the level of understanding you need to be successful in each line of business.

Organizations use this Five Forces Analysis to help them make a qualitative evaluation of their strategic position at the start of the development or review process. This technique is suited to helping you identify potential opportunities, especially if you are considering entering a new market, or you are seeking effective ways to differentiate yourself from the competition.

KEY POINTS

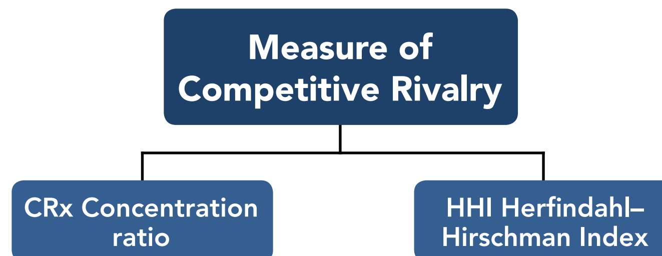
- ✔ Porter's Five Forces model is regarded as a credible and practical alternative to the widely used SWOT Analysis.
- ✔ The five key factors the model uses to identify and evaluate potential opportunities and risks are: competitive rivalry, threat of new entrants, threat of substitutes, bargaining power of suppliers, and bargaining power of customers.
- ✔ The model was designed for use at the line-of-business level.
- ✔ It is often used at the start of the development or review process.

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

Competitive Rivalry

One of the keys to success for organizations is their ability to understand their competitors' actions and marketing strategies. The degree to which rivalry exists among competitors varies between industries and the market sectors within them.

Regardless of the number of key competitors your organization faces it is vital for its longevity that you understand the differences between your rivals. This knowledge is essential when developing your strategy, and it cannot be achieved by simply using two indices, e.g. size of organization and market share, or sales revenue and market value.



There are two indices that are commonly used when judging your competitive edge and those of your rivals:

- CRx—Concentration Ratio
- HHI—Herfindahl-Hirschman Index

The Concentration Ratio (CRx)

This ratio measures the total output produced in an industry by a given number of corporations. It will be expressed by using its initials followed by a number. For example,

> ***CR4 gives the market share of the four largest companies***
>
> ***CR5 gives the market share of the five largest companies, and so on.***

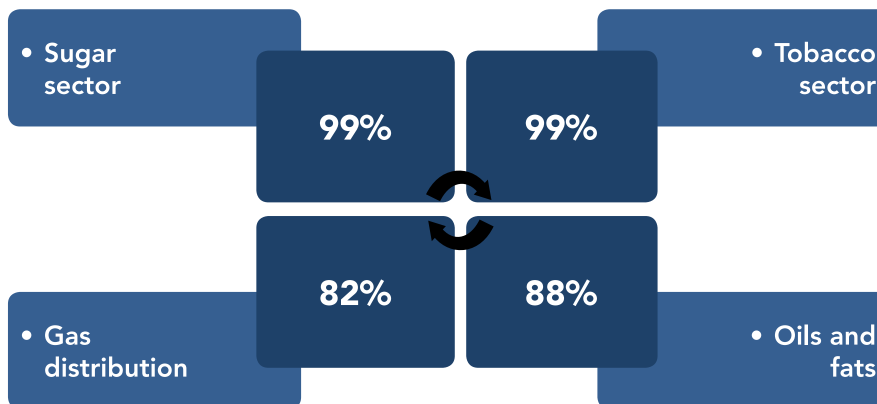
Concentration ratios are usually used to show the extent of market control of the largest firms in the industry.

Concentration ratios range from 0 to 100 percent. The levels reach from No, Low, or Medium, to High and 'Total' concentration.

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

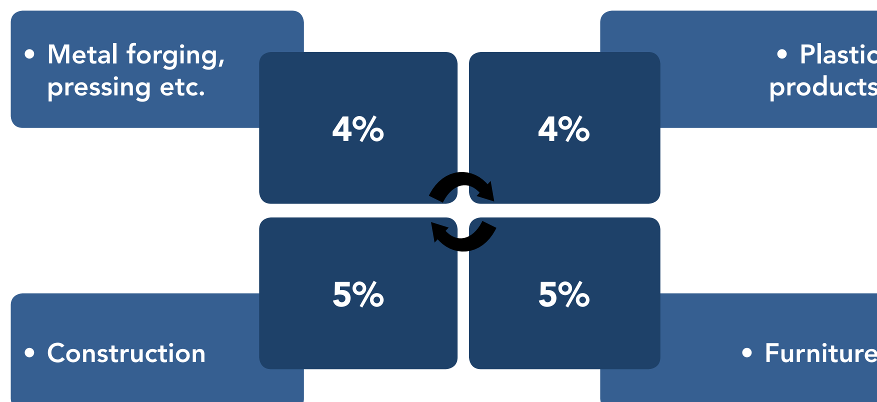
If for example CR4=0%, the four largest firms in the industry would not have any significant market share. If CR4=100% then the four largest firms would account for the total market share.

The following diagram illustrates the CR5 Concentration Ratio of four UK industry sectors that are close to monopolies.



The diagram shows that for both the sugar and tobacco sectors the top 5 companies account for 99% of the market share. The top 5 suppliers of oils and fats account for 88% of the market share, while the top 5 suppliers of gas account for 82%.

In those sectors where the Concentration Ratio is low there are many rivals and no one organization has a substantial market share. Competition in such markets is high. Those sectors within the UK that have the lowest CR5 ratios are shown below.



ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

In all of these sectors the five largest producers account for only 4–5% of the total market share.

The Herfindahl-Hirschman Index (HHI)

This is also referred to as the Herfindahl Index, and it is more complex than the CRx. For the purposes of this eBook it is only important that you understand that it measures the size of organizations in relation to the industry and indicates the amount of competition amongst these organizations. The HHI also gives a greater weighting to larger organizations.

This index ranges from a value of zero, which indicates a very large number of small organizations, to one, which represents a monopoly. Therefore the closer the HHI Index is to zero the greater the level of competition within the sector.

There are published figures available for these indices that can offer you an insight into the degree of competition in your sector. You can look these up using the SIC (Standard Industrial Classifications) that match or are a best fit for your operations.

Factors Affecting Competitive Rivalry

There are several things that increase the intensity of rivalry that you are likely to experience:

- A larger number of firms
- Slow market growth
- High fixed costs
- High storage costs
- Low switching costs
- Low levels of product differentiation
- High exit barriers

The larger the number of organizations involved in a market the greater the level of rivalry. This is because the organizations have more competition when trying to win customers and buying resources so rivalry can be quite aggressive. This becomes more intense the more equal each company's market shares is as they all strive to become the market leader.

The same aggressive rivalry can be seen where the market is growing slowly. Organizations will be experiencing declining sales, both in terms of revenue and volume, and will strongly defend their existing market share, while attempting to gain a greater share.

In markets where fixed costs make up the majority of the total costs, organizations need to produce at full capacity to ensure they achieve the lowest unit costs through economies of scale. These high volumes mean that the organization has to adopt a hard line when fighting for market share against its rivals.

Where organizations have a product that is highly perishable or has high storage costs they are always seeking to be the first to market so that they can achieve the best prices. This creates an environment of intense competition to win customers.

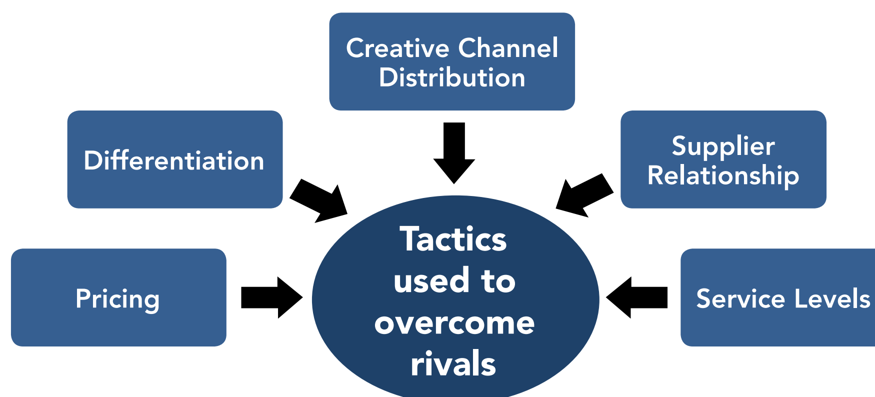
In circumstances where it is relatively easy for a customer to switch between products and suppliers rivalry will also be high. A good example of this can be seen in wholesale fresh vegetable, meat, and fish markets. This situation also illustrates another influence on the intensity of rivalry: where there is little differentiation between your product and that of your competitors. The effect of this can, however, be reduced by developing and maintaining a strong brand identity for your product.

There are circumstances where the costs of abandoning the investment in the specialist assets required to manufacture your product are too great. When faced with high exit barriers most organizations continue to operate despite the product often being unprofitable.

The competitive forces are not static; they alter in response to changes within their environment and the impact of technological advances. Many industries have seen changes in the dominance of the market leaders as new entrants and technology alter the dynamics of a market. For example:

> ***The introduction of smartphones by Apple and Samsung seriously reduced the market share of previous market leaders like Nokia.***
>
> ***In the world of books, Amazon has completely changed consumer expectations about the level of choice and delivery times. The addition of eBook readers, such as the Kindle, and instant downloads has further intensified the level of competition in this once conservative market.***

These factors often lead to price wars and hard-hitting advertising campaigns, as well as the launching of additional product ranges in an attempt to retain market position.



ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

There are several strategies organizations adopt when protecting their market share in situations of intense competition:

- Altering pricing policies
- Improving product differentiation
- Seeking ways to use channel distribution more creatively
- Exploiting relationships with suppliers
- Improving service levels

Historically, one of the most popular strategies for gaining market share was to cut prices. This approach carries serious risks as it is easy for competitors to do the same and this has the effect of resetting your customers' expectations in terms of price. By reducing your revenue you also limit your ability to invest in research and promotion, which may further weaken your position if your have a brand name to protect.

Organizations generally prefer to grow or maintain their market share by improving the unique features their products offer in comparison with those of rivals. However, this is not a strategy available to straightforward, uncomplicated products.

Another important strategy, which is more suitable to some products than others, is to make use of a new distribution channel. For example:

> ***In 1995 Dell computers used the Internet to allow customers to specify their requirements and have a PC built to their own specifications. Selling direct to customers in this way made it impossible for traditional electrical retailers to compete on range or price.***

In other instances a large retailer or manufacturer can use their market position to gain preferential prices from their suppliers. This allows them to be more profitable or sell at a lower price without reducing their profit margins. Alternatively, they could use their influence to encourage the supplier to produce a branded or special edition product exclusively for them, which can also give them an advantage over their rivals.

For many organizations, improving the level of service they provide offers a significant opportunity to gain or retain market share. For example:

Next-day delivery has made Internet suppliers, such as Amazon, competitive with high street retailers. You can order when the stores are closed and get your book or DVD the next day. The benefit is that you've made your purchase from your home or office without the inconvenience of having to visit the store when it's open.

In some cases, altering your service levels can provide you with an element of differentiation that is difficult for your rivals to replicate.

KEY POINTS

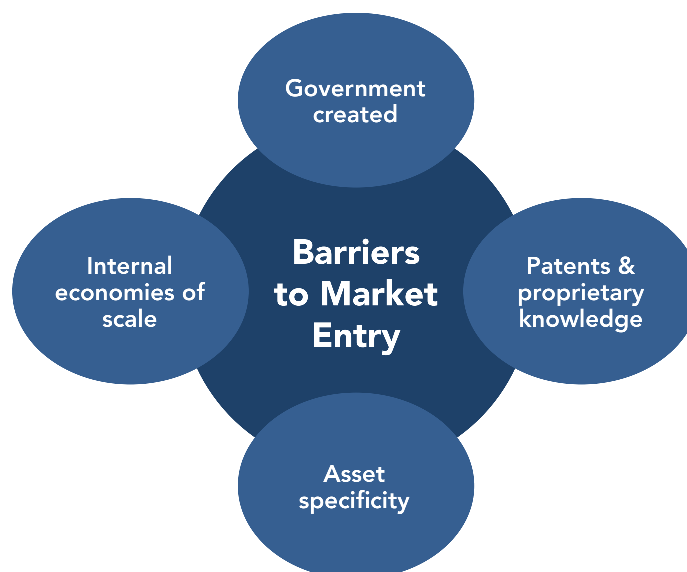
- ✔ Competitive Rivalry can be measured using the Concentration Ratio and the Herfindahl–Hirschman Index.
- ✔ The intensity of competitor rivalry increases with:
  - ✔ A larger number of firms
  - ✔ Slow market growth
  - ✔ High fixed costs
  - ✔ High storage costs
  - ✔ Low switching costs
  - ✔ Low levels of product differentiation
  - ✔ High exit barriers
- ✔ Common strategies for protecting market share include:
  - ✔ Altering pricing policies
  - ✔ Improving product differentiation
  - ✔ Seeking ways to use channel distribution more creatively
  - ✔ Exploiting relationships with suppliers
  - ✔ Improving service levels

Threat of New Entrants

The number of potential new entrants into a market varies considerably and is a key factor you need to quantify. Sectors that require high levels of investment and expertise are much harder for new organizations to break into and challenge the existing providers, which protects the profit levels of the existing players.

If your market is one that has a common technology base, little brand awareness or loyalty, and is one in which the distribution channels are accessible to all sizes of organization, then you will usually find it is easy for new rivals to enter your market.

On the other hand, if your market requires the acquisition of patents or proprietary know-how, many potential new entrants will be deterred because of the large up-front investment required. It is also more difficult for new rivals to enter a market if brand loyalty is high, as your customers are far less likely to switch to another brand.



New rivals may also be prevented from entering your market sector if the distribution channels are restricted.

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

There are several barriers that can prevent additional rivals entering the market. If you are an existing supplier then you have the opportunity to create or capitalize on this competitive advantage. These barriers to entry can come from a variety of sources:

- Created by governments
- Patents and proprietary knowledge
- Asset specificity
- Internal economies of scale
- Barriers to exit

Sometimes governments create or permit what are seen as 'natural' monopolies, such as utility organizations. In this instance it is seen as more beneficial to the consumer to have one provider that is regulated by an industry body than it is to have several providers competing.

A significant entry barrier for many modern markets is one of proprietary knowledge or patents, which provide their organizations with a significant competitive advantage for a period of time. This time enables them to recover their investment and become profitable.

In a similar way, those industries that require an organization to invest in highly specialized equipment and technology or plants create a barrier to potential entrants because of the monies involved. This is compounded by the fact that the equipment or technology cannot be easily used for other products or services. This is known as 'asset specificity.' Existing organizations in this situation will aggressively defend their market share and investment from potential rivals.

Many markets are only attractive to organizations if they can attain levels of production and costs that give them internal economies of scale. This is called the Minimum Efficient Scale (MES) and is a commonly known figure for many industries. The higher the MES figure the greater the deterrent it is to entering a market.

Finally, where an organization is unable to leave a market, it has to compete. This is known as a barrier to exit, and it operates in a similar way to barriers to entry. Profitability can be high in a situation where organizations have both high entry and exit barriers as long as all providers operate efficiently.

Difficulties in exiting a market are most likely to occur where there are inter-related businesses within it, in situations that require an organization to acquire specialist assets, or where there are high exit costs, for example decommissioning units or equipment. If your organization's assets can easily be disposed of, there are few costs involved if you want to withdraw, and the operating unit is independent of your main organization then you are operating in a market that is easy to exit.

KEY POINTS

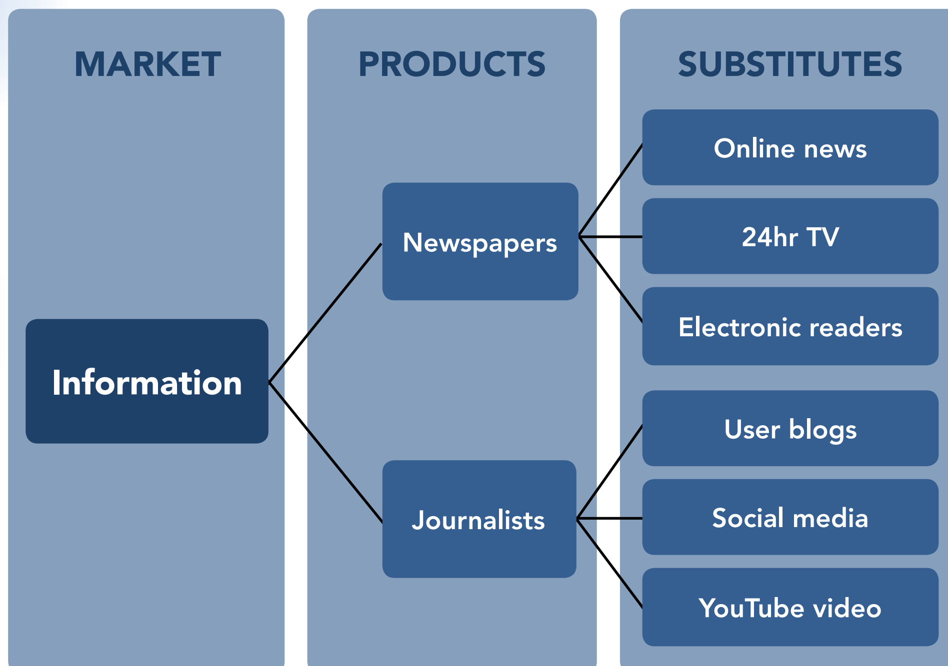
- ✔ The number of potential new entrants into a market will be low if there are barriers to entry created by:
  - ✔ Governments
  - ✔ Patents and proprietary knowledge
  - ✔ Asset specificity
  - ✔ Internal economies of scale

Threat of Substitutes

Substitutes can be defined as those products or services that meet a particular consumer need but are available in another market. A substitute product is a product from *another industry* that offers benefits to the consumer similar to those of the product produced by the firms within the industry.

The threat of substitution affects the competitive environment for the organizations in that industry and influences their ability to achieve profitability because consumers can choose to purchase the substitute instead of the industry's product.

This can be a significant issue as it constrains the ability of suppliers to raise prices, even though this may be in all of their interests. For example, the price of newspapers is constrained by the existence of online news and TV news channels. The availability of these (more or less) free services has meant that the newspaper industry has been unable to increase its prices in line with rising costs even though almost all newspaper publishers would like to do so.



As part of your analysis using Porters Five Forces model, you need to look outside of your own industry and think about those substitutes that pose a threat to your market. If for example, you are a traditional book publisher selling novels through bookstores, you would need to consider other ways in which the consumer's need (to enjoy a novel) could be met.

These might include:

Purchasing books in a supermarket

Purchasing books from an online supplier

Purchasing eBooks directly from the author

Purchasing an audio recording or video

This example reminds users of Porter's framework that defining your market is important, as it assumes that high street booksellers and online retailers are not in the same 'industry' despite both having books as one of their products. The more substitutes that are on offer in your market the more sensitive or 'elastic' consumers will be to changes in your product's price because of the number of alternatives.

The threat of substitutes is high when:

Consumer switching costs are low
Substitute product is cheaper than industry product
Substitute product quality is equal or superior to industry product quality
Substitute performance is equal or superior to industry product performance

The threat of substitutes is low when:

Consumer switching costs are high
Substitute product is more expensive than industry product
Substitute product quality is inferior to industry product quality
Substitute performance is inferior to industry product performance
No substitute product is available

KEY POINTS

- ✔ 'Threat of substitutes' means the availability of a product that the consumer can purchase instead of the industry's product.
- ✔ The availability of close substitute products can make an industry more competitive and decrease profit potential for the firms in the industry.
- ✔ It shapes the competitive structure of an industry and influences an organization's ability to achieve profitability.

Bargaining Power of Suppliers

Any organization needs raw materials and this creates buyer-seller relationships between the market and the suppliers. The distribution of power within such relationships varies, but if it lies with the supplier then they can use this influence to dictate prices and availability. You need to assess the balance of power within your own market as part of using Porter's model.

Suppliers may work together to increase bargaining power, although this is usually against the law in developed countries where legal redress is available if such actions are discovered.

Factors that increase supplier's power:

- Raise prices without affecting demand
- Can reduce quantity supplied
- Can cooperate formally or informally
- Few substitutes are available
- Their 'product' is critical to end product
- Can impose switching costs on customers
- Have potential to integrate downstream

There are several characteristics that indicate the extent of a supplier's power and one is that they are able to increase their prices without this having a detrimental effect on the volume of sales. Another is the ability to create informal or even formal agreements that control pricing and supply. Most developed countries have extensive anti-trust laws and regulations in place to deter and penalize suppliers caught in this type of activity, but recent anti-trust court cases involving software, finance, healthcare, utility, and oil companies suggest that supplier collusion is still widespread.

Rather than raise prices, suppliers in a strong bargaining position can choose to reduce the quantity of the product available, something that is most effective if there are few

substitutes buyers can switch to. Suppliers are also in a strong position if the product or service they supply is an essential component of the end product.

Other ways in which suppliers can dominate include imposing costs or penalties on their customers if they decide to change to another supplier. In addition, a supplier may decide that their best strategy for growth and profitability is to purchase or create agreements with other organizations further down the supply chain in order to increase control of distribution channels.

Well-known examples of strong suppliers are:

- DeBeers—dominates the diamond market.
- Microsoft—practically dominates the market for personal computer operating systems.
- Intel & AMD—dominate the market for processor chips.
- Cargill & Monsanto—dominate the agricultural seed production market.

Whilst some industries do have dominant suppliers this is not the case for all. In industries where the product is standardized you are likely to find a large number of competitive suppliers. The food processing industry is a good example of this because agricultural produce can be bought from a variety of suppliers, both large and small. This is the same for any market involving commodity products.

A high concentration of purchasers is an indication that suppliers in that market have a weaker bargaining position. This is one of the characteristics of the music industry, where there are a limited number of powerful record companies (buyers) and an almost unlimited number of hopeful musicians (suppliers). The mismatch between these groups means that supply far outstrips demand, and consequently most musicians are prepared to work for a pittance, or for free, in the hope getting their product into the market.

Suppliers are also in a weak position if a purchaser could relatively easily adopt a policy of backward integration. This factor, combined with global access to numerous suppliers, is a key characteristic of the automotive components market, where there is only a handful of customers. To be excluded from supplying a particular car manufacturer could be disastrous for the supplier who often has to work on very low profit margins.

KEY POINTS

- ✔ Supplier bargaining power is high where:
  - ✔ There are few suppliers and many buyers
  - ✔ The cost of switching from one supplier's product to another supplier's product is high
  - ✔ Suppliers can begin to produce the buyer's product themselves
  - ✔ The buyer is not price sensitive and is uneducated regarding the product
  - ✔ The supplier's product is highly differentiated
  - ✔ The buyer does not represent a large portion of the supplier's sales
  - ✔ Substitute products are unavailable in the marketplace
- ✔ If the opposite is true for any of these factors, supplier power is low.

Bargaining Power of Customers

Your organization should also assess the extent to which its customers or buyers have bargaining power. In a situation where customers have a strong position they can bring considerable pressure to the market and demand improved quality and/or lower prices.

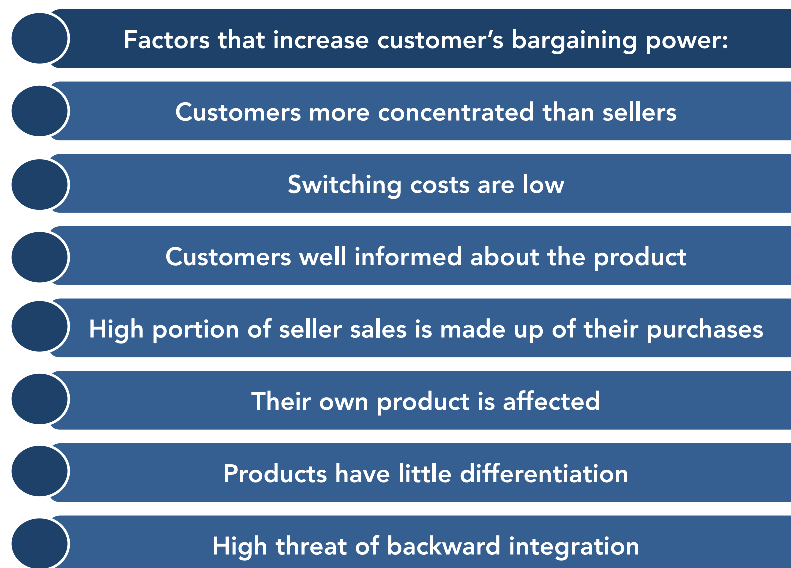
There are several key factors that increase the bargaining power of customers:

- Customers are more concentrated than sellers
- Switching costs for customers are low
- Customer is well educated regarding the product
- Customer is price sensitive
- A large portion of a seller's sales is made up of customer purchases
- The customer's own product or service is affected
- There is little differentiation between products
- The threat of backward integration is high.

The extent to which customers can influence the market depends on their level of concentration or how well organized they are. Many small farmers produce fruit and vegetables, which they are contracted to sell to their customers, the supermarkets. The

smallholder has to meet the strict quality control imposed on them by the supermarkets or risk losing the contract. This enables the supermarkets, as the customers, to exert pressure on these small suppliers.

The degree to which customers are able to manipulate market forces is swayed by the how significant their purchases are in terms of the supplier's revenue.



Customers also have significant bargaining power in markets where it is easy for them to transfer between different products without suffering any transfer costs. A good example of this is the washing powder market, which without brand loyalty has no financial impact if you swap between products. This power decreases if the customer has to spend more time or effort in switching between products or services.

In situations where the customer's purchase represents a substantial proportion of their total costs they will be more price sensitive and the buying process will be more protracted. This results in the bargaining power being greater for the customer, and the seller will have to be more persuasive during the sales process.

Also, the more knowledge the customer has about the product the greater their bargaining power will be, as they will be aware of the product's benefits and features. They may also be aware of how your product compares to that of your competitors, and in many instances may be familiar with your costing structure and prepared to use this intelligence to bargain.

This occurred in the automotive industry in the 1980s when manufacturers seconded their own staff to component makers on the understanding that the component makers would become the manufacturers' 'preferred' supplier. This gave the manufacturers extensive inside knowledge about the costing structure of the components, which eventually enabled them to dictate prices and margins to the producers.

In markets where the products have little to differentiate them, brand loyalty is low or non-existent, and the product is available from multiple suppliers, customers are usually motivated to purchase based on price rather than any concept of loyalty. This gives the customers greater bargaining powers than suppliers, who may only win new customers temporarily because their offer is better at that particular point in time.

Another example of this shift in bargaining power is that of the component-type market. Your product in this case may have a well-known brand but as this product is only one of many items in the end product that has no perceived benefit over any other component then customers will buy on price. A commonly cited example is that of Duracell batteries. Although their batteries last longer, manufacturers who supply batteries in their products don't use them because this aspect does not affect the sale of their product.

Customers may also decide to set up their own production of your product as part of a strategy of integrating backwards down the supply chain. This threat of satisfying their need for your product internally keeps prices competitive.

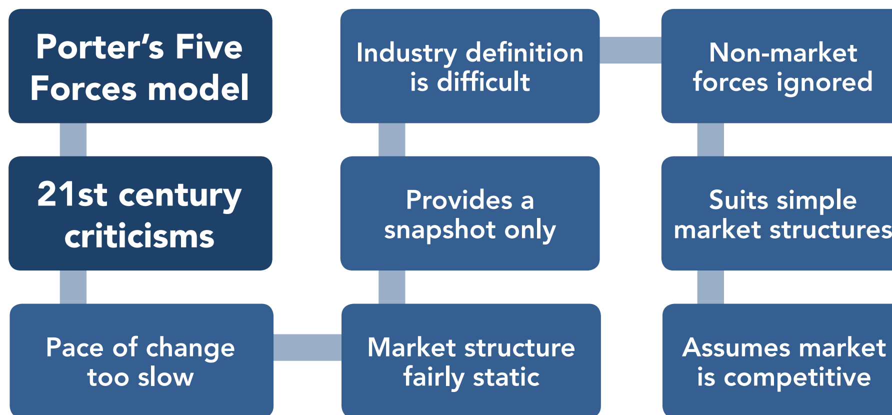
KEY POINTS

There are several key factors that increase the bargaining power of customers:

- ✔ Customers are more concentrated than sellers
- ✔ Switching costs for customers are low
- ✔ Customer is well educated regarding the product
- ✔ Customer is price sensitive
- ✔ A large portion of a seller's sales is made up of customer purchases
- ✔ The customer's own product or service is affected
- ✔ There is little differentiation between products
- ✔ The threat of backward integration is high.

Summary

Whilst the Porter's Five Forces model has its benefits there are certain considerations you should bear in mind when using it. Many of these come from the fact that it was developed in an environment that was quite different to the one organizations find themselves operating in today.



These considerations are:

- Pace of change is now more rapid.
- Market structures were seen as relatively static.
- The model provides you with only a snapshot of your environment.
- It can be difficult to define the industry
- The model does not consider non-market forces
- The model is most applicable for analysis of simple market structures
- The model is based on the idea of competition.

Today's market is considerably altered from that of the late 1970s, especially in terms of the rate of change industries experience and the stability of market structures. Changes in technology occur regularly and their impact is virtually instant and can cause significant disruption to a market.

Very few market structures have remained static, and new entrants, the availability of venture capital, barriers to entry, and supply chain relationships can change to such a

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

degree that an organization's business model needs to change radically to retain its market position. Technological changes have also significantly reduced the length of time a product has between its conception and its market maturity.

Without regular updates, any knowledge gained from using Porter's model will quickly be out of date as it was only designed to provide a snapshot of any particular market. The model is not able to provide you with meaningful information about how best to take preventive actions. It does, however, offer suggestions as to where the challenges and threats to your organization are most likely to occur through its examination of substitutes.

Sometimes the dynamics of industries and corporations can make it difficult to define the market or industry. For example, is Walmart in the general retailing market, or should they consider each major product line separately, and if so to what degree? Should they class all electrical goods together, split them into white goods and electronic goods, or split them at some lower level (audio, video, computers, small kitchen appliances, white goods, etc.)? The wide variety of product lines that many modern organizations carry create their own difficulties when defining markets and this may need to be done at a product level to be meaningful.

Porter's model also has difficulty in integrating the complexities of today's markets with the frequent inter-relations and product groups of organizations. If your organization defines its market segment too narrowly to fit into the model there is a risk that key elements may be overlooked, for example legislation and the interactions between sellers and buyers.

Organizations have to respond to more than just market forces. They need to be aware of, understand the implications of, and respond to government legislation, corporate ethics, and their social responsibilities. The internal culture and ethos of an organization will also carry significance when forming a strategy. Porter's model is also unable to incorporate the implications of strategic alliances or the sharing of skills and resources as a more effective way to respond to opportunities.

Despite these factors, Porters Five Forces model has a role to play in helping management to evaluate and assess their current market environment. It provides an excellent foundation for the further research and intelligence gathering needed to formulate an organization's future strategy.

Other Free Resources

The Free Management eBooks website offers you over 100 free resources for your own professional development. Our eBooks, Checklists, and Templates are designed to help you with the management issues you face every day. They can be downloaded in PDF, Kindle, ePub, or Doc formats for use on your iPhone, iPad, laptop or desktop.

eBooks—Our free management eBooks cover everything from accounting principles to business strategy. Each one has been written to provide you with the practical skills you need to succeed as a management professional.

Templates—Most of the day-to-day management tasks you need to do have already been done by others many times in the past. Our management templates will save you from wasting your valuable time re-inventing the wheel.

Checklists—When you are working under pressure or doing a task for the first time, it is easy to overlook something or forget to ask a key question. These management checklists will help you to break down complex management tasks into small controllable steps.

FME Newsletter—Subscribe to our free monthly newsletter and stay up to date with the latest professional development resources we add every month.

Social Media—Share our free management resources with your friends and colleagues by following us on LinkedIn, Facebook, Twitter, Google+, and RSS.

Visit www.free-management-ebooks.com

ISBN 978-1-62620-999-2 © www.free-management-ebooks.com

References

Aguilar F.J. (1967), *Scanning the Business Environment*, Macmillan.

Cadle, J., Paul, D. and Turner, P. (2010), *Business Analysis Techniques, 72 Essential Tools for Success*, BCS The Chartered Institute for IT.

Johnson, G., Whittington, R. and Scholes, K. (2009), *Exploring Corporate Strategy with MyStrategyLab,* Financial Times/Prentice Hall.

Kotler, P., Keller, K.L., Brady, M., Goodman, M., and Hansen, T. (2009), *Marketing Management,* Pearson Education.

McDonald, M. and Wilson, H. (2011), *Marketing Plans: How to Prepare Them, How to Use Them,* 7th Edition, John Wiley.