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INVESTING FUNDAMENTAL ANALYSIS

Porter's Five Forces Explained and How to Use the Model

The fundamentals you need to analyze an industry's weaknesses and strengths

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What Are Porter's Five Forces?

Michael Porter's five-force strate
published in the *Harvard Busine*
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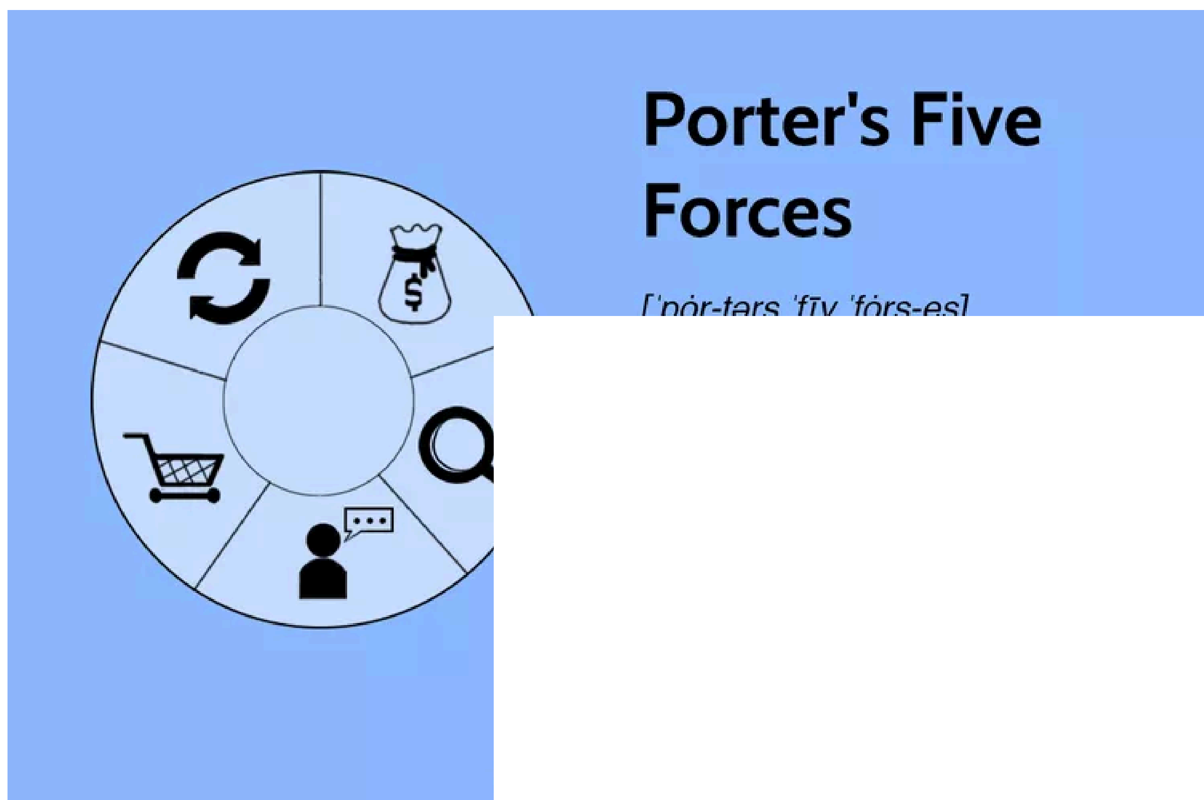
KEY TAKEAWAYS

- Porter's five forces are used to identify and analyze an industry's competitive forces.
- The five forces are competition, the threat of new entrants to the industry, supplier bargaining power, customer bargaining power, and the ability of customers to find substitutes for the sector's products.
- The model guides businesses in determining the intensity of competition and potential profitability within their market, helping them better understand where power lies in their sector.
- Porter's model was meant to critique "perfectly competitive" business models, unlike real-world markets where competitors aren't just rivals and firms in specific industries tend to rise and fall together.
- Criticisms mounted against the model include that it's too static, doesn't speak to the advantages or problems of specific companies, doesn't account enough for collaborative business models, and doesn't apply as well to quick-changing markets.



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Strategic analysis at the time of Porter's article tended not only to love acronyms (SWOT, PEST, PESTEL, BCG Matrix, ETPS, etc.) but also models focused on the internal dynamics of individual companies.[2]

While it would be unfair to suggest they ignored the competitive environment companies face, they were typically vague while doing so; e.g., the "opportunities" and "threats" of SWOT analysis were too "macro" for many dealing with the challenges of specific industries.

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Porter's 1979 article was also a broadside against the theoretical models found in the curriculums of the major business schools, where future strategists dealt with a "perfectly competitive" market characterized by equilibrium and no specific firm influencing prices—a model they were unlikely to find in the real world.

The first sentence of Porter's 1979 article could hardly be less controversial: "The essence of strategy formula

It's the following sentence that, i consequential: "Yet it is easy to v pessimistically."[1]

Rather than viewing competitior competitors, which is his first for four others: the bargaining powe

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Porter's Five Forces

1. Competitive Rivals

Porter's first force is what we usually mean when discussing business competition. We think of Pepsi and Coca-Cola for soft drinks, Apple and Samsung for smartphones, Nike and Adidas for sneakers, and Ford and General Motors for autos.

Indeed, some of these rivalries are so influential that consumers split almost culturally among those who have an iPhone, drive a Ford, or prefer Netflix to Hulu. Thus, it's no accident that we also consider business competition chiefly a war among rivals.

Such rivalries can lead to price wars, high-priced marketing battles, and races for slight advances that could mean a competitive advantage. These tactics can stimulate companies to make ever better products but also erode profits and market stability. [3]

Several factors contribute to the intensity of competitive rivalry in an industry:

- **The number of competitors**: The more competitors in an industry, the more fierce the rivalry, each fightin
- **Industry growth**: In an expan dramatic because the market need to fight for customers— 20th century and the dot-com stagnant or declining industr for a larger piece of a shrinkir media industries of today.

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search), competition tends to be intense because customers can easily switch. However, if a company offers a unique product or service or has earned brand loyalty, this can reduce competitive rivalry. Apple, Inc. (AAPL) comes to mind in tech goods, just as Rao's Italian sauces or King Arthur flour do in your supermarket aisles, each charging a higher price given its style, taste, or whatever makes it unique.

- **Exit barriers**: When it's difficult or costly for companies to leave the industry due to specialized assets, contractual obligations, or emotional attachment, they may choose to stay and compete, even if the market's prospects grow dimmer by the day. The airline industry is a classic example. Airlines have high costs for their assets, contractual obligations (leasing agreements and labor contracts), and regulatory requirements, which means that when airlines face a shrinking market—or even an unprofitable route—they can't retreat from the market quickly.
- **Fixed costs**: Porter notes that if an industry has high fixed costs, companies have a "strong temptation" to cut prices rather than slow production when demand slackens. Paper and aluminum manufacturing are two good examples that Porter gives. [1]

2. Potential for New Entrants in an Industry

Industries where new firms can enter more easily almost always have lower profit margins, and the firms involved each have less market share. [1]

The sector for local restaurants has relatively low entry requirements: there aren't significant investments or regulatory hurdles to surmount before opening to the public. Thus, it's also the case that your favorite restaurant may not stay open for long, given the
entrance of new restaurants ope

Here are factors in measuring ho

- **Economies of scale**: Industrie
costs face less of a threat fron
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the threat of entry.

- **Capital requirements**: High startup costs for equipment, facilities, etc., can deter new entrants. For example, starting a car manufacturing business requires significant investment, so until Tesla Inc.'s (TSLA) growth in the early 2010s, Americans from the 1950s could have named the major U.S. car brands of the early 2000s.
- **Access to distribution channels**: If existing firms control the distribution channels—retail stores, online platforms, cable infrastructure, etc.—then new entrants would need to find a way to replicate that structure while competing with the established firms on price, a tricky proposition.
- **Regulations**: Licenses, safety standards, and other regulatory standards can create barriers, making it too ungainly or costly for new firms to enter the market. Examples would include those looking to build new hotels in downtown areas or supply power to a region.
- **Switching costs**: If it's costly or difficult for customers to switch from existing firms to new entrants, the threat of entry is lower.

3. Supplier Power

Suppliers are powerful when they are the only source of something important that a firm needs, can differentiate their product, or have strong brands.[1]

When the power of suppliers in an industry is high, this raises costs or otherwise limits the resources a firm needs. Here are some factors used to measure the supplier power of an industry:

- **The number of suppliers**: When few firms can give a company something it needs to stay in business, eac prices or reduce quality withc
- **Uniqueness**: If a supplier pro substitute, it is more dominai supplier.
- **Switching costs**: If it's costly c they have more power. Busin increase.

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making it difficult for their former buyers to compete once they decide to enter the market themselves.

- **Industry importance**: Some sectors are tightly intertwined, such as automotive suppliers and the major auto companies or the semiconductor and tech industries, which can balance the power between the suppliers and those in the sector. This is because the supplier needs these buyers to do well so that it can, too. When a supplier can just as easily sell its products elsewhere, that gives it a great deal more power.

4. Customer Power

When customers have more strength, they can exert pressure on businesses to provide better products or services at lower prices. This force intensifies under certain conditions:

- **The number of buyers**: The fewer the buyers, the more they have power. In sectors like aerospace manufacturing, each major airline, the industry's customers, has significant leverage in negotiations and can demand favorable terms because the sellers depend on their business.
- **Purchase size**: Just like you head off to the big box stores to buy in bulk for a cheaper per-unit cost on whatever now fills up your garage, major retail chains like Walmart Inc. (WMT) buy in large volumes and can negotiate better terms and discounts.
- **Switching costs**: In industries like telecommunications, where it's easy for consumers to switch providers, companies such as Verizon Communications, Inc. (VZ) and AT&T Inc. (T) have to offer competitive terms.
- **Price sensitivity**: In the fast-fashion industry, where customers are highly price-sensitive, brands must l
consumers.
- **Informed buyers**: In many se
competitive terrain well, and

> **Important:** Porter chose th
> static, so business must co
> an industry change.

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threat to the companies in that industry.[2]

Here are some ways that this threat can be magnified:

- **Relative price performance**: If the cost of a substitute is lower and its performance is comparable or better, customers are likely to switch to the substitute. For instance, streaming services like Netflix became a substitute for traditional cable TV, providing a lower price that soon threatened the cable industry.
- **Customer willingness to go elsewhere**: The threat is high if buyers find it easy to switch to a substitute. For example, in the early 2010s, customers found switching from taxis to ride-sharing apps like Uber or Lyft cheaper and easier.
- **The sense that products are similar**: If buyers perceive that there are few differences between your product and a substitute, even if there are, they may be more likely to switch.
- **Availability of close substitutes**: Though this sounds the same as the last bullet point, you have to strategize differently around it. There are times when potential substitutes are very different from a company's products but consumers still treat them as the same. But in other cases, there are genuinely similar products in the market and the threat of substitutes is high, such as between brand-name and generic medications.

Competitive Measures

When published, Michael Porter's framework marked a departure from the then-dominant models of business strategy, steeped in classic competition theory.[4]

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While helpful for learning basic p
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Business strategists need to deal with sectors where information asymmetry, product differentiation, and significant entry and exit barriers are common. Firms do have some control over prices, contradicting classical assumptions.

In short, where economists assumed most markets acted like the model, for Porter, most firms are in industries with entrenched interests and different supplier and customer relations. They need strategies for dealing with anything but perfect competition. [5]

Mild-to-Intense Competition

Porter's five forces come together in different ways for any given sector. He labeled industry competition as ranging from "intense" to "mild," with profits harder to achieve as the intensity in a sector rises. In intensely competitive industries, all or most of the five forces have a strong influence. [1]

The fast food industry is Porter's own example, which still remains the case. [1]

In this sector, there's a fierce rivalry among established players like McDonald's and Burger King, high bargaining power for suppliers and customers, and a relentless threat of new entrants and substitutes, all of which means profits are constantly getting squeezed for anyone in the sector.

Meanwhile, in "mild" industries, such as commercial aircraft manufacturing, there are weaker forces. Here, low supplier bargaining power, a minimal threat of new entrants, and a lack of direct substitutes (like commercial aircraft for long-distance travel) help form a

Applying the Model

Since his 1979 *Harvard Business*
books on strategic analysis, inclu
force model. He's also become v
performing an industry analysis:

2. **Identify the key players**: Specify and group the major actors in the sector into strategic categories based on relevant criteria.
3. **Assess the strategic strengths**: This means evaluating the firm and its industry to determine the better and worse strategies that can be applied.
4. **Analyze the industry structure**: This involves examining the overall structure of the industry, particularly the factors that influence how profitable it is.
5. **Evaluating the competitive forces:** Only once you've done the above does Porter advise doing a detailed analysis of the five competitive forces, assessing their positive and negative effects, and then looking forward to any changes in these forces ahead.
6. **Identify the factors you have some control over**: Here, you want to pinpoint aspects of the industry structure that could be influenced by competitors, new market entrants, or your firm. In sum, what can be changed?

Critiques of the Five Forces

Porter's model helped reframe the understanding of competition. It wasn't confined to direct rivals but extended to suppliers and customers—traditionally viewed in a transactional light.

Suppliers, especially those with unique resources or enjoying a monopoly, could dictate terms, lower profits, or, in extreme cases, forward-integrate into the buyer's industry. Customers, too, wield power, especially when buying in bulk or when they can just go elsewhere quickly or choose to bypass companies for in-house products. [2]

But the model has its pitfalls. Fo
emphasis on sector affiliation. P
which can sideline an individual
This industry-centric view may n
characteristics can change the g
rules. [6]

simultaneously in several sectors. Industries are no longer isolated silos; instead, they often intersect and interact, leading to a far more complex environment than the model suggests. [4]

Porter's five-force model has also been critiqued for not adequately addressing the role of partnerships and collaboration. [6]

While Porter certainly entertained a competitive model where rivalry wasn't just a war to the death, the problem is that he didn't go far enough. In an interconnected global economy, alliances and cooperative strategies are often as pivotal to success as having a competitive advantage, a factor that the model doesn't explicitly consider.

Another critique that can be filed under "going in the right direction but not far enough" is that the model is too static and fails to account for industries with rapid changes in technology and consumer preferences. While effective in stable sectors, critics say it doesn't apply well to industries marked by fast-paced innovation and shifting demand. [2]

Most strikingly, Porter's model generalizes competition, implying a seemingly uniform industry structure for every market. [2]

This might overlook the unique competitive scenarios in different sectors and the increasing importance of the nontraditional strategies involved in digital transformation and platform-based competition.

How Does Porter's Five Forces Differ From SWOT Analysis?

Both are strategic planning tools
force model analyzes the compe
intensity and the bargaining pow
meanwhile, is broader and asses
weaknesses as well as its externa

It can assist in strategic planning
excels and faces obstacles, helpi

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How Can Porter's Five Forces Address the Effects of Globalization on an Industry?

Porter's model has been used to analyze how globalization affects industry competition. For instance, globalization lowers barriers to entry in specific industries, intensifying the threat of new entrants from different regions.[2]

It can also expand the pool of potential substitutes and alter the power dynamics with suppliers and customers worldwide. While Porter and others were doing this analysis for industries facing global competition decades ago, it's still applicable to sectors undergoing this process in the 2020s.

How Does Porter's Five-Forces Model Apply to the AI Sector?

Using the model, we would begin by looking at the competitive rivalry. The AI sector is marked by high competition with key players ranging from tech giants to small startups. Rapid advances mean companies have to move quickly simply to maintain relevance. We would then need to gauge the power of suppliers of data sets and specialized hardware, which have ample power since AI firms rely heavily on these resources.

Moving to consumers, we would need to review the needs of individual consumers and whether larger companies can force AI firms to negotiate better services and prices for them. The field of AI has been attracting many new entrants, but there are significant barriers to entry, including high initial research and development costs. Lastly, the threat from the last force, the possibility of substitutes, depends on what a firm wants to do with its AI-based technology. The more complicated the tasks the AI is given, the more likely other goods and services can't su

The Bottom Line

Porter's five-forces model sets ou
competitive landscape: the pow
entrants and substitutes, and co

While the economic terrain has e
has updated his work ever since,

their own logic and structural forces at play.

Today, while the five-forces model may require adapting it to rapid technological change and the importance of collaboration across many industries, it's a reliable way to help guide companies needing to navigate industry-specific challenges in their competitive strategy.

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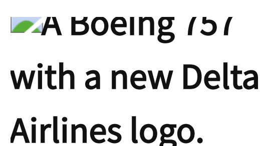
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