How to use Porter's Five Forces

Regardless of your industry, Porter's Five Forces is a powerful tool business owners can use to understand:

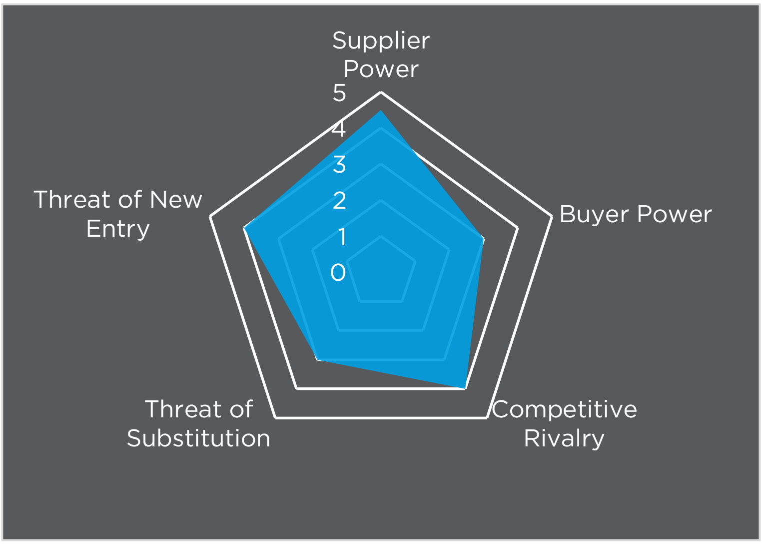
- The dynamics of the industry their business operates in
- The key drivers of its profitability
- How your actions may affect your industry position and level of profitability

If you do not have a good understanding of these factors, you will struggle to strengthen your position and maximise your profitability and success.

What is Porter's Five Forces?

For any industry there are five key forces that impact on average industry profitability:

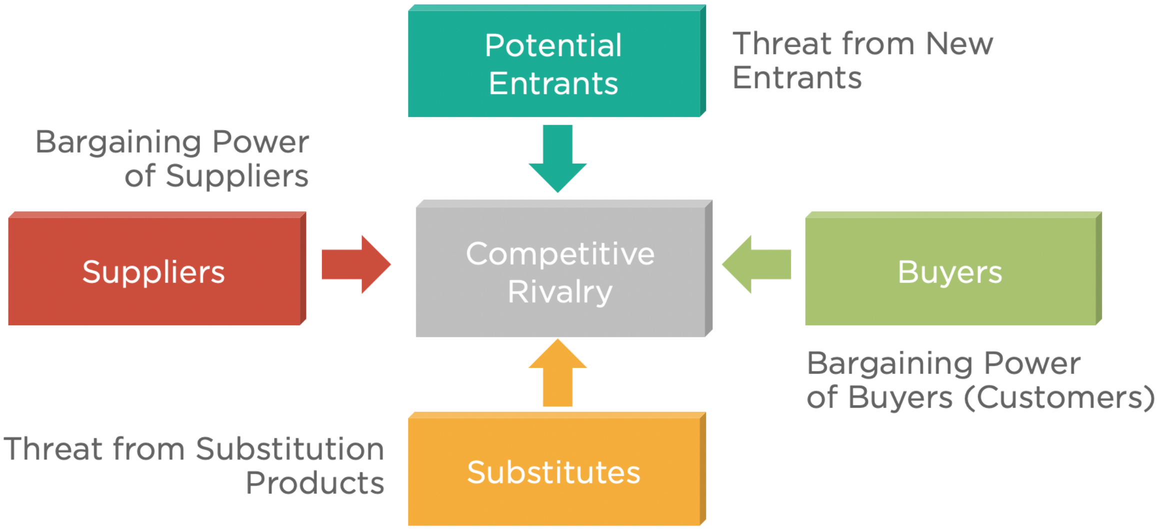
1. The threat of new entrants
2. Supplier power
3. Buyer power
4. Competitive rivalry
5. The threat of substitutes



Why Porter's Five Forces are Important

Undertaking a Porter's Five Forces analysis assists with understanding your industry and your position within it, potentially allowing you to:

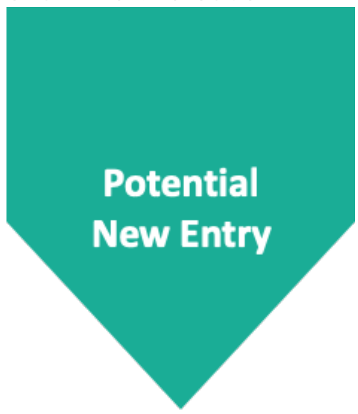
- Shape the industry by influencing the drivers of industry profitability
- Avoid strategies that may lower industry profitability
- Pre-empt the impact that competitors will have on industry profitability
- Take action to strengthen your position within the industry



By understanding the direction and magnitude of the drivers of industry profitability, you can better equip yourself to exploit and adapt to them.

Threat of New Entrants

The starting point for the Porter's Five Forces analysis is to examine the ease with which new competitors can enter your industry.



The lower the barriers to entry, the greater the potential for new entrants to enter and increase industry capacity. As capacity increases, participants pursue greater market share placing pressure on prices, costs and investment returns – it lowers industry profitability.

The threat of entry into an industry depends on the barriers to entry and includes:

- Economies of scale – the degree to which existing industry participants have a cost advantage because of the scale of their operations
- Demand economies – the extent to which buyers are prepared to pay more for a product because of the size of the business supplying it
- Customer switching costs – the extent to which customers incur costs to switch to new entrants

- Capital requirements – the size of the initial capital investment required to enter the industry

- Resource advantages – the extent to which existing industry participants have a quality or cost advantage, due to factors other than size

- Distribution channels – the extent to which existing industry participants have preferred access to important distribution channels

- Government policy – the extent to which the Government may protect existing industry participants and hinder entry into the industry

- Expected retaliation – the extent to which existing industry participants are perceived as likely to retaliate against new entrants

Bargaining Power of Suppliers

The bargaining power of suppliers in Porter's Five Forces analysis refers to the ability of suppliers to capture more of the industry's profits by:

- Driving up the prices of your inputs

- Lowering the quality or level of service attributed to your inputs

- Transferring other costs associated with your inputs to you

- The more powerful suppliers, the greater their ability to squeeze profits out of an industry and away from your business.

- Supplier power increases with:

- Concentration – the degree to which the supplier dominates their industry relative to you

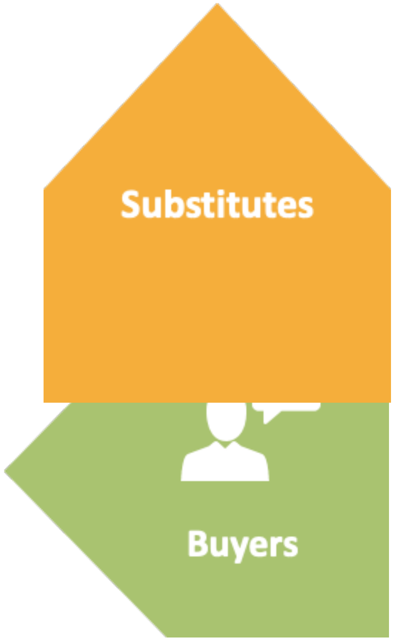
- Industry independence – the suppliers lack of reliance on your industry for its profits

- Switching costs – the costs you incur in switching to a new supplier

- Differentiation – the degree to which a suppliers' products and services are differentiated, and competition is not based on price

- Integration – the potential for suppliers to successfully enter your industry

Bargaining Power of Buyers



Within the context of the Porter's Five Forces analysis, the bargaining power of buyers refers to ability of your customers to reduce industry profitability by:

- Driving down your prices
- Demanding better quality or service at a given price
- Promoting rivalry (playing businesses off against each other to secure lower prices)

The more powerful a buyer is, the greater their ability to squeeze profits out of an industry and away from your business.

Similar to supplier power, buyer power is influenced by changes in concentration, industry independence, switching costs, differentiation, integration and price sensitivity.

Threat of Substitution

The threat of substitution refers to the extent to which customers can find different products and services to satisfy their needs.

The easier it is for customers to find and use suitable alternative products and services, the greater the threat of substitution.

The threat of substitutes is high where the:

- Alternatives provide a comparable price and performance outcome
- Buyer switching costs are low

In a global and intensely competitive marketplace, the potential for substitution is a major risk for many businesses. Close attention needs to be given to the alternatives customers have and developments in other industries that may create new alternatives.

Competitive Rivalry

Competitive rivalry refers to the competition amongst existing industry participants to capture more market share and industry profits. This encompasses price discounting, new product introductions, quality improvements and marketing.

The strength of rivalry and its impacts on industry profitability depends on:

- The level of intensity with which businesses compete with one another
- Whether businesses compete on the same dimensions (imitate each other)

The intensity of rivalry increases where:

- Competitors are evenly matched
- Industry growth is slow, and participants fight over existing market share
- There are high barriers to exiting the industry, which prevent businesses leaving despite low profitability
- A business seeks leadership in the industry for reasons other than those based purely on economic factors and profitability
- Businesses cannot read each other’s tactics and take action that inadvertently intensifies competition

Where competition is based on competitive dimensions other than price, industry profitability is less likely to be eroded.

Fortitude Business Consulting Pty Ltd | ABN 30 167 470 662 | ACN 167 470 662
T 1300 551 040
E grant.ferry@fortitudebusinessconsulting.com.au
W https://fortitudebusinessconsulting.com.au

How to use Porter's Five Forces

To use the Porter's Five Forces, you assess the underlying drivers of each competitive force to determine which ones are strong, which ones are weak and why. This is done by:

- Brainstorming each of the five forces of industry profitability
- Making an assessment of the factors impacting on industry profitability
- Analysing the extent to which each of the factors are getting stronger or weaker

By understanding these factors, you can make more informed decisions about how to manage them - how to exploit them or adapt to them.

Implementing Porter's Five Forces

The purpose of Porter's Five Forces is to help business owners understand:

1. The key drives of industry profitability
2. Their magnitude and how they are trending
3. What action may be required to manage the opportunities and threats they present.

Once you have examined each force, you can then summarise them and factor them into your strategy development and implementation processes.

If you would like to learn more about how to use Porter's Five Forces to understand the drivers of your industry's profitability, give the team at Fortitude Business Consulting a call today on 1300 551 040.