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Guideline Porter's Five Forces Model

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Contents

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What is Porter's Five Forces Model?

Source: De Bruin, L. (2016). Porter's Five Forces. https://www.business-to-you.com/porters-five-forces/

Porter's *Five Forces* is a model that identifies and analyses five competitive forces, which shape every industry and facilitates the determination of an industry's weaknesses and strengths. It a simple but powerful tool, which can be used in order to identify the main sources of competition in an industry or sector. *Porter*'s *Five Forces* analysis is most commonly used in order to identify an industry's structure and to determine corporate strategy. *Porter*'s *Five Forces* model can be implemented in every field of the economy in order to determine the level of competition within the industry and augment a company's long-term profitability.

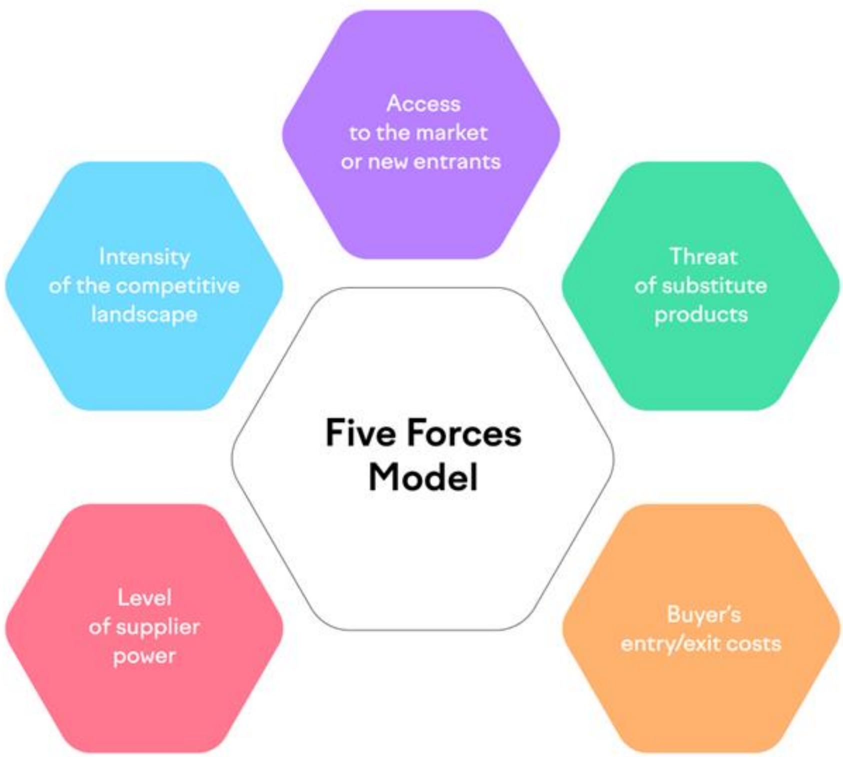
The *Porter's Five Forces model* is bears the name of a leading economist and Harvard Business School professor, Michael E. Porter. He is the author of more than 18 books over 125 articles on corporate and competitive business strategy. His models and theories received numerous awards leading to his recognition as one of the most influential economists in history.

Along with the Five Forces Framework, his *Value Chain, Diamond*, and *Four Corners Analysis* models completely changed macro-business analysis around the world.

Porter's Five Forces is a business analysis model that facilitates the explanation of how and why various industries are able to sustain different levels of profitability.

The *Porter's Five Forces model* is generally put into use in order to analyse the industry structure of a company as well as its corporate strategy. Porter has catalogued five unquestionable forces that play the pivotal role in shaping every market and industry in the world, with some caveats. The five forces are frequently used to measure competition intensity, attractiveness, and profitability of an industry or market.

Apprehending *Porter's Five Forces* and how they are implemented into an industry, can allow a company to adjust its business strategy to better use its resources to generate higher earnings for its investors. Five Forces analysis can be used to guide business strategy to increase competitive advantage. When you understand the forces affecting your industry, you'll be able to adjust your strategy, boost your profitability, and stay ahead of the competition. For example, you could take fair advantage of a strong position or improve a weak one, and avoid taking wrong steps in the future.



Source: Zhukova, N. (2021). Understanding Porter's Five Forces Model (How to Use It + Template). https://www.semrush.com/blog/understanding-porters-five-forces-model

In this guideline, we are going to explain what Porter's Five Forces are, and how they are best implemented, so that you can conduct your own analysis for your business

What are the Porter's Five Forces?

According to Porter, there are five forces, which constitute the leading sources of competitive pressure within an industry. He has highlighted that it's substantial not to mistake these for more fleeting factors, such as industry growth rates, government interventions, and technological innovations. According to Porter, these are temporary factors, while the Five Forces are permanent parts of an industry's structure.

1. Competition in the industry

The first of *Porter's Five Forces* regards the number and strength of your competitors. How many rivals do you have? Who are they, and how does the quality of their products and services compare with yours?

HIGH COMPETITIVE RIVALRY	LOW COMPETITIVE RIVALRY
Large number of competitors	Small number of competitors
Slow industry growth	Fast industry growth
Tough exit barriers	Low exit barriers
High fixed costs	Low fixed costs
High switching costs between providers	Low switching costs between providers
Little product differentiation	A variety of different products on offer

Source: Hart, D. Porter's Five Forces: Increase The Profitability of Your Business. MBA. https://www.thepowermba.com/en/business/porters-five-forces

The larger the number of competitors, along with the number of equivalent products and services they offer, the lesser the power of a company. Suppliers and buyers seek out a company's competition if they are able to offer a better deal or lower prices. Conversely, when competitive rivalry is low, a company has greater power to charge higher prices and set the terms of deals to achieve higher sales and profits.

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In an industry where rivalry is intense, companies attract customers by aggressively cutting prices and launching high-impact marketing campaigns. However, this can make it easy for suppliers and buyers to go elsewhere if they feel that they're not getting a good deal from you. On the other hand, where competitive rivalry is minimal, and no one else is doing what you do, then you'll likely have tremendous competitor power, as well as healthy profits.

Example: Considering the airline industry in the United States, we see that the industry is extremely competitive due to the entry of low-cost carriers, the tight regulation of the industry wherein safety become paramount leading to high fixed costs and high barriers to exit, and the fact that the industry is very stagnant in terms of growth at the moment.

2. Threat of New Entrants into an Industry

A company's power is also affected by the new entrants into its market. The less time and money it costs for a competitor to enter a company's market and be an effective competitor, the more an established company's position could be significantly weakened. If it takes little money and effort to enter your market and compete effectively, or if you have little protection for your key technologies, then rivals can quickly enter your market and weaken your position.

INCREASED THREAT OF NEW ENTRANTS	DECREASED THREAT OF NEW ENTRANTS
No household brand names	Several established brand names
Low initial capital investment required	High capital investment required
Easy access to suppliers and distribution channels	Limited access to suppliers and distribution channels
Weak government regulations	Strong government regulations
Unlikely risk of retaliation	High risk of retaliation
Proprietary technology is not required	Proprietary technology a necessity

Source: Hart, D. Porter's Five Forces: Increase The Profitability of Your Business. MBA.
https://www.thepowermba.com/en/business/porters-five-forces

An industry with strong barriers to entry is ideal for existing companies within that industry since the company would be able to charge higher prices and negotiate better terms.

Example: The threat of new entrants in the airline industry can be considered as low to medium. It takes quite high investments to start an airline company (e.g. purchasing aircrafts). What is more, new entrants need licenses, insurances, distribution channels and other qualifications that are not easy to obtain when you are new to the industry (e.g. access to flight routes). In addition, the existing players have built up a large base of experience over the years to cut costs and increase service levels. A new entrant is likely to not have this kind of expertise, therefore creating a competitive disadvantage right from the start.

3. *Power of Suppliers*

Supplier power is identified by how easy it is for suppliers to increase their prices. How many potential suppliers do you have? How unique is the product or service that they provide? And how expensive would it be to switch from one supplier to another?

The power of suppliers in the *Porter's Five Forces* model is affected by the number of suppliers of key inputs of a good or service, how unique these inputs are, and how much it would cost a company to switch to another supplier. The fewer suppliers to an industry, the more a company would depend on a supplier. As a result, the supplier has more power and can drive up input costs and push for other advantages in trade. On the other hand, when there are many suppliers or low switching costs between rival suppliers, a company can keep its input costs lower and enhance its profits.

SUPPLIER POWER HIGH	SUPPLIER POWER LOW
Low dependance on sector for income	High dependance on sector for income
Less competition than buyer	More competition than buyer
High switching costs between buyers	Low switching cost between buyers
Threat of buyer backward integration	Little threat of buyer backward integration
Patented or differentiated products	Non-patented or low differentiation between products
No product substitution	Various substitute products

Source: Hart, D. Porter's Five Forces: Increase The Profitability of Your Business. MBA. https://www.thepowermba.com/en/business/porters-five-forces

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Example: The bargaining power of suppliers in the airline industry can be considered very high. When looking at the major inputs that airline companies need, we see that they are especially dependent on fuel and aircrafts. Nevertheless, these inputs are highly affected by the external environment over which the airline companies themselves have no control. The price of aviation fuel is subject to the fluctuations in the global market for oil, which can change wildly because of geopolitical and other factors.

4. *Power of Customers*

The ability that customers have to drive prices lower or their level of power is one of the five forces. It is affected by how many buyers or customers a company has, how significant each customer is, and how much it would cost a company to find new customers or markets for its output. A smaller and more powerful client base means that each customer has more power to negotiate for lower prices and better deals. A company that has many, smaller, independent customers will have an easier time charging higher prices to increase profitability.

BUYER POWER HIGH	BUYER POWER LOW
Few buyers	Many buyers
Standardized industry product	Non-standardized industry product
Low switching cost between vendors	High switching cost between vendors
Threat of buyer backward integration	Little threat of buyer backward integration
High-volume purchases	Low-volume purchases
Downstream customer influence	Little to no downstream customer influence

Source: Hart, D. Porter's Five Forces: Increase The Profitability of Your Business. MBA. https://www.thepowermba.com/en/business/porters-five-forces

Example: Bargaining power of buyers in the airline industry is high. Customers are able to compare prices of different airline companies. Customers nowadays are likely to fly with different carriers to and from their destination if that would lower the costs. Brand loyalty therefore doesn't seem to be that high.

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5. Threat of Substitutes

The last of the five forces focuses on substitutes and the likelihood of your customers finding a different way of doing what you do. For example, if you supply a unique software product that automates an important process, people may substitute it by doing the process manually or by outsourcing it. Substitute goods or services that can be used in place of a company's products or services pose a threat. Companies that produce goods or services for which there are no close substitutes will have more power to increase prices and lock in favourable terms. When close substitutes are available, customers will have the option to forgo buying a company's product, and a company's power can be weakened.

Example: With regard to the airline industry, it can be said that the general need of its customers is traveling. It may be clear that there are many alternatives for traveling besides going by airplane. Depending on the urgency and distance, customers could take the train or go by car. As a result, the threat of substitutes in the airline industry can be considered at least medium to high.

Full list of Porter's Five Forces factors:

Threat of new entrants	Bargaining power of suppliers	Bargaining power of buyers	Threat of substitute products or services	Rivalry among existing competitors
- Barriers to entry - Economies of scale - Brand loyalty - Capital requirements - Cumulative experience - Government policies - Access to distribution channels - Switching costs	- Number of suppliers - Size of suppliers - Uniqueness of each supplier's product or service - Focal company's ability to substitute - Switching costs	- Number of customers - Size of each customer order - Differences between competitors - Price sensitivity - Buyer's ability to substitute - Buyer's information availability - Switching costs	- Number of substitute products available - Buyer propensity to substitute - Relative price performance of substitute - Perceived level of product differentiation - Switching costs	- Number of competitors - Diversity of competitors - Industry concentration - Industry growth - Quality differences - Brand loyalty - Barriers to exit - Switching costs

Source: De Bruin, L. (2016). Porter's Five Forces. https://www.business-to-you.com/porters-five-forces/

How to use the *Porter's Five Forces* model?

Porter's Five Forces Model facilitates the evaluation of the attractiveness of a particular industry, assess investment options, and measure competition intensity.

To use the model, start by looking at each of the five forces in turn, and how they apply in your industry. Ask yourself the following questions:

- ✓ Is rivalry between competitors intense or do you tend to retain customers relatively easily?
- ✓ Do you have lots of suppliers to choose from or do you rely heavily on a small group of suppliers?
- ✓ Is buyer power high or low?
- ✓ Would buyers find it easy to substitute your product or service?
- ✓ Do new competitors find it easy to enter the market or is it difficult?

After you've considered these questions, write down each of the five forces, and summarize the size and scale of each using your findings.

Finally, think about how your analysis will likely impact you. Bear in mind that few situations are perfect – but evaluating your industry using *Porter's Five Forces* can help you to think through what you could change to improve your competitive position and increase your profitability.

In addition, if you find yourself in a structurally weak position, the model can help you elaborate new ideas about what you can do to move into a stronger one.

Use this model where there are at least three competitors in the market. Avoid using the model for an individual firm; it is designed for use on an industry basis

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Benefits of Five Forces model.

Porter's Five Forces model enables organisations to understand the factors affecting profitability in a specific industry, and can help to inform decisions relating to: whether to enter a specific industry; whether to increase capacity in a specific industry; and developing competitive strategies.

Porter's Five Forces model: conclusion.

Porter's Five Forces Model is an effective tool for apprehending the main competitive forces at work in an industry. This model facilitates the evaluation of the attractiveness of an industry, and pinpoint areas where you can adjust your strategy to improve profitability.

According to Porter, the five main forces that can impact the competitiveness of an industry are:

1. ***Competitive Rivalry:*** the strength of competition in the industry.
2. ***Supplier Power:*** the ability of suppliers to drive up the prices of your inputs or raw materials.
3. ***Buyer Power:*** the strength of your customers to drive down your prices.
4. ***The Threat of Substitution:*** the extent to which different products and services can be used in place of your own.
5. **The Threat of New Entry:** the ease with which new competitors can enter the market (and potentially drive down your prices).

By determining how each force affects your organization, and by identifying its strength and direction, you can easily evaluate your competitive position. Afterwards, you can effectively consider what strategic changes you need to make to deliver long-term profit.

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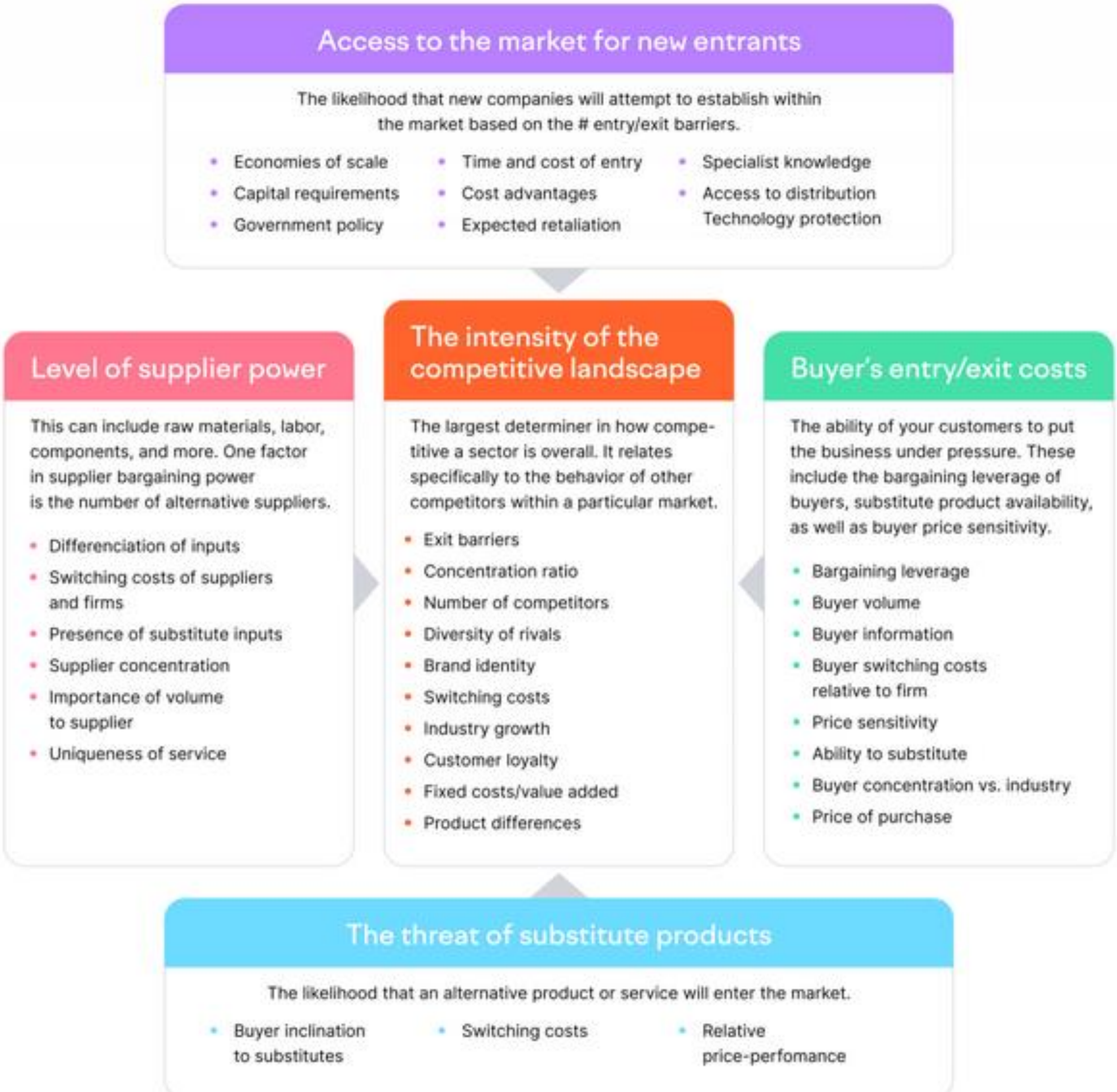

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