Industry Analysis Framework – Michael Porter

Competition in an industry is rooted in its underlying economic structure and goes well beyond the behaviour of current competitors. The state of competition in an industry depends on five basic competitive forces, whose collective strength determines the ultimate profit potential in the industry (measured in terms of long-run return on invested capital).

Force #1: Threat of Entry

New entrants to an industry bring new capacity, the desire to gain market share, and often substantial resources. Prices can be bid down or incumbents' costs inflated as a result, reducing profitability.

The threat of entry into an industry depends on the *barriers to entry,* coupled with the reaction from existing competitors. If barriers to entry are high and/or the newcomer can expect sharp retaliation from entrenched competitors, the threat of entry is low. There are six major sources of barriers to entry:

1. Economies of Scale.

Economies of scale refer to declines in the unit costs of a product (or operation or function that goes into producing a product) as the absolute volume per period increases. Economies of scale deter entry by forcing the entrant to come in at large scale and risk strong reaction from existing firms, or to come in at small scale and accept a cost disadvantage - both undesirable options. Scale economies are present in nearly every business function, including manufacturing, purchasing. R&D, marketing, service network, sales force utilization, and distribution.

Example: Scale economies in production, R&D, marketing, and service are probably the key barriers to entry in the mainframe computer industry, as Xerox and General Electric discovered in the 1990's.

2. *Product Differentiation.*

Product differentiation means that established firms have brand identification and customer loyalties, which stem from past advertising, customer service, product differentiation , or simply being first in the industry. Differentiation creates a barrier to entry by forcing entrants to spend heavily to overcome existing customer loyalties.

Example: Product differentiation is probably the most important entry barrier in cosmetics, where brand awareness equals sales.

3. ***Capital Requirements.***

The need to invest large financial resources in order to compete creates a barrier to entry, particularly if the capital is required for risky or unrecoverable up-front advertising or R&D.

Example: Xerox created a major capital barrier to entry in copiers when it chose to rent copiers rather than sell them outright. Greatly increasing its need for working capital.

4. ***Switching Costs.***

Switching costs are one-time buyer costs of switching from one supplier's product to another. Switching costs may include employee retraining costs, costs of new ancillary equipment, cost and time in testing or qualifying a new source , need for technical help as a result of reliance on seller engineering aid, product redesign, or even the psychic costs of severing a relationship.

Example: For Intra-Venus solutions and kits used in hospitals, procedures for launching solutions to patients differ among competitors' products and the hardware for hanging IV bottles is not compatible between them. In this case switching encounters great resistance from nurses responsible for administering this treatment and investment in hardware is also required.

5. ***Access to Distribution Channels.***

A barrier to entry can be created for a new entrant's if it is difficult to secure distribution for its product. To the extent that logical distribution channels for the product have already been served by established firms, the new entrant must persuade the channel to accept its products through such strategies as price breaks and co-operative advertising allowances. These additional costs reduce profits.

Example: The manufacturer of a new food product must persuade the retailer to give it space on fiercely competitive supermarket shelves using promotions, paying up front shelf fees, and buy-back arrangements. A barrier to entry can be so high that to surmount it a new firm must createa new distribution channels similar to what Timex did in the watch industry.

6. ***Government Policy.***

Government can limit or even foreclose entry into industries, with such controls as licensing requirements and limits on access to raw materials. Restrictions can also extend from air and water pollution standards and product safety and efficacy requirements.

Example:

Alcohol retailing, drugs and retailing of pharmaceuticals are regulated by law.

NOTE: Cost Disadvantages Independent of Scale. Established firms may have **cost** advantages not replaceable by potential entrants, no matter what their size and attained economies of scale. These advantages might include: Proprietary product technology, Favourable access to raw materials, Favourable locations, Government subsidies, Learning or experience curve know how.

Force #2: Rivalry

Rivalry among existing competitors takes the familiar form of jockeying for position using tactics like price competition, advertising battles, product introductions, and increased customer service, warranties. Rivalry occurs because competitors either feel the pressure or see the opportunity to improve their position. **Intense rivalry is the result of a number of interacting structural factors:** 1.

1. ***Numerous or Equally Balanced Competitor.***

When firms are numerous, the likelihood of mavericks is great and some firms may believe they can make moves without being noticed. When there are fewer firms, they may be relatively balanced in terms of size and perceived resources; but this creates instability because they may be prone to fight each other and have the resources for sustained and vigorous retaliation. On the other hand, if the industry is highly concentrated or dominated by one or a few firms, then there is little mistaking relative strength. The leader or leaders can impose discipline as well as play a co-ordinating role in the industry through such devices as price leadership.

2. ***Slow Industry Growth***

Slow industry growth turns competition into a market share game for firms seeking expansion.

3. ***High Fixed or Storage Costs***

High fixed costs create strong pressures for all firms to fill capacity, which often leads to rapidly escalating price cutting when excess capacity is present.

4. ***I.ack of Differentiation or Switching Costs***

Where the product or service is perceived as a commodity or near commodity, buyers base their choice largely on price and service. This leads to pressures for intense price and service competition. Product differentiation, on the other hand, creates layers of insulation against competitive warfare because buyers have preferences and loyalties to particular sellers.

5. ***Capacity Augmented in l.arge Increments*** .

Where economies of scale dictate that capacity must be added in large increments, capacity additions can **be** chronically disruptive to the industry supply/demand balance, particularly where there is a risk of bunching capacity additions. The industry may face recurring periods of over-capacity and price cutting.

6. ***Diverse Competiton***

Competitors diverse in strategies. origins, personalities, and relationships to thei r parent companies have differing goals and differing strategies for how to compete, and may continually run head-on into each other in the process.

Example: A business unit that is a cash cow in its parent company's portfolio will behave differently from one that is being developed for long-run growth.

7. *High Strategic Stakes*

Rivalry in an industry becomes even more volatile if a number of firms have high stakes in achieving success there.

Example: A diversified firm may place great importance on achieving success in a particular industry at the expense of profitability, in order to further its overall corporate strategy.

8. *High Exit Barriers*

*E*xit barriers are economic, strategic, and emotional factors that keep companies competing in businesses even though they may be earning low or even negative returns on investment. The major sources of exit barriers are as follows:

- Specialised assets. Assets highly specialised to the particular business or location have low liquidation values or high costs of transfer or conversion.
- Fixed costs of exit. These include labour agreements, resettlement costs, and maintaining capabilities for spare parts.
- Strategic inter-relationships. These are inter-relationships between the business unit and others in the organization in terms of such factors as image.
- Emotional barriers. This translates as an unwillingness to make an exit decision due to such factors as loyalty to employees, fear for one's career, and pride.
- Government and social restrictions. These restrictions on exit result from concerns of the effect of job loss on regional economies.

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Force #3: Substitute Products

All firms in an industry are competing, in a broad sense, with industries producing substitute products. Substitutes limit an industry's potential returns by placing a ceiling on achievable prices. The more attractive the price offered by substitute products or services, the firmer the lid on total industry profits. Industries with heavy use of technology are especially susceptible to substitutes.

Example: Electronic alarm systems represent a potent substitute for security guards. Moreover, they can only become more important because labour intensive guard services face inevitable cost escalation, whereas electronic systems are highly likely to improve in performance and decline in costs.

Force #4: Buyers' Bargaining Power

Buyers compete with the industry by forcing down prices, bargaining for higher-quality or more services, and playing competitors against each other all at the expense of industry profitability. The power of each of the industry's important buyer groups depends on a number of characteristics of its market situation and on the relative importance of its purchases from the industry compared with its overall business. A buyer group is powerful if the following circumstances hold true:

1. It is concentrated or purchases large volumes

If a large portion of sales is purchased by a given buyer, a raise in the importance of that buyer’s business is the result. Large-volume buyer's are particularly potent forces if heavy fixed costs characterise the industry, emphasising the importance of keeping capacity filled.

2. ***The product it purchases represents a significant fraction of the buyer' s costs or purchases***

Here buyers are prone to shop for a more favourable price. When the product sold by the industry in question is a small fraction of the buyer's cost, buyers are usually much less price-sensitive.

3. ***The products it purchases are standard or undifferentiated***

Buyers, sure that they can always find alternative suppliers, may play one company against another.

4. ***It faces few switching costs***

Switching costs lock the buyer to particular sellers. Conversely, the buyer's power is enhanced if the seller faces switching costs.

5. ***It earns low profits.***

Low profits create great incentives to lower purchasing costs.

6. ***Buyers pose a credible threat of backward integration.***

If buyers either are partially integrated or pose a credible threat of backward integration, they are in a position to demand bargaining concessions. Buyer power can be partially neutralised when firms in the industry offer a threat of forward integration into the buyer's industry.

7. ***The industry's product is unimportant to the quality of the buyer's products or services***

When the quality of the buyer's products is very much affected by the industry's product , buyers are generally less-price-sensitive.

8. ***The buyer has full information.*** Having full information about demand, actual market prices, and even supplier costs usually gives the buyer greater bargaining leverage than when such information is lacking. Wholesalers and retailers can gain significant buyer power over manufacturers when they can influence the consumer's purchasing decisions, as they do in audio components, jewellery, appliances, sporting goods, and other products.

Force #5: Suppliers' Bargaining Power

Suppliers can exert bargaining power over participants in an industry by threatening to raise prices or reduce the quality of purchased goods and services. Powerful suppliers can thereby squeeze profitability out of an industry unable to recover cost increases in its own prices.

The conditions that make suppliers powerful tend to mirror those that make buyers powerful. A supplier group is powerful if the following apply:

1. ***It is dominated by a few companies and is more concentrated than the industry it sells to***

Suppliers selling to more fragmented buyers will usually be able to exert considerable influence in prices, quality, and terms.

2. ***It is not obliged to contend with substitute products for sale to the industry***

The power of even large, powerful suppliers can be checked if they compete with substitutes.

3. ***The industry is not an important customer of the supplier group***

When suppliers sell to a number of industries and a particular industry does not represent a significant fraction of sales, suppliers are much more prone to exert power. If the industry is an important customer, suppliers' fortunes will be closely tied to the industry and they will want to protect it through reasonable pricing and assistance in such activities as R&D and lobbying.

4. ***The supplier's product is an important input to the buyer's business***

Such an input is important to the success of the buyer's manufacturing process or product quality. This increases the supplier's power particularly when the input is not storable, thus preventing the buyer from building up stocks of inventory.

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5. ***The supplier group's products are differentiated or it has built up switching costs***

Differentiation or switching costs facing the buyers cut off their options to play one supplier against another.

6. ***The supplier group poses** a **credible threat** of **forward integration***

This provides a check against the industry's ability to improve the terms on which it purchases.

Conclusion

The underlying structure of an industry, as reflected in the strength of the five forces, should be distinguished from the many short-run factors that can affect competition and profitability in a transient way. Although such factors may have tactical significance, the focus of the industry structure analysis is on identifying the basic underlying characteristics of an industry rooted in its economics and technology that shape the arena in which competitive strategy must be set. Businesses will each have unique strengths and weaknesses in dealing with industry structure and industry structure can and does shift over time.