Porter's Five Forces Analysis

If you?ve ever listened to Warren Buffett talk about investing, you?ve heard him mention the idea of a company?s moat. The moat is a simple way of describing a company's competitive advantages. Company's with a strong competitive advantage have large moats, and therefore higher profit margins. And investors should always be concerned with profit margins.

This article looks at a methodology called the Porter?s Five Forces Analysis. In his book Competitive Strategy, Harvard professor Michael Porter describes five forces affecting the profitability of companies. These are the five forces he noted:

1. Intensity of rivalry amongst existing competitors
2. Threat of entry by new competitors
3. Pressure from substitute products
4. Bargaining power of buyers (customers)
5. Bargaining power of suppliers

These five forces, taken together, give us insight into a company's competitive position, and its profitability.

Rivals

Rivals are competitors within an industry. Rivalry in the industry can be weak, with few competitors that don?t compete very aggressively. Or it can be intense, with many competitors fighting in a cut-throat environment.

Factors affecting the intensity of rivalry are:

- Number of firms ? more firms will lead to increased competition.
- Fixed costs ? with high fixed costs as a percentage of total cost, companies must sell more products to cover those costs, increasing market competition.
- Product differentiation ? Products that are relatively the same will compete based on price. Brand identification can reduce rivalry.

New Entrants

One of the defining characteristics of competitive advantage is the industry?s barrier to entry. Industries with high barriers to entry are usually too expensive for new firms to enter. Industries with low barriers to entry, are relatively cheap for new firms to enter.

The threat of new entrants rises as the barrier to entry is reduced in a marketplace. As more firms enter a market, you will see rivalry increase, and profitability will fall (theoretically) to the point where there is no incentive for new firms to enter the industry.

Here are some common barriers to entry:

- Patents ? patented technology can be a huge barrier preventing other firms from joining the market.
- High cost of entry ? the more it will cost to get started in an industry, the higher the barrier to entry.
- Brand loyalty ? when brand loyalty is strong within an industry, it can be difficult and expensive to enter the market with a new product.

Substitute Products

This is probably the most overlooked, and therefore most damaging, element of strategic decision making. It?s imperative that business owners (us) not only look at what the company?s direct competitors are doing, but what other types of products people could buy instead.

When switching costs (the costs a customer incurs to switch to a new product) are low the threat of substitutes is high. As is the case when dealing with new entrants, companies may aggressively price their products to keep people from switching. When the threat of substitutes is high, profit margins will tend to be low.

Buyer Power

There are two types of buyer power. The first is related to the customer?s price sensitivity. If each brand of a product is similar to all the others, then the buyer will base the purchase decision mainly on price. This will increase the competitive rivalry, resulting in lower prices, and lower profitability.

The other type of buyer power relates to negotiating power. Larger buyers tend to have more leverage with the firm, and can negotiate lower prices. When there are many small buyers of a product, all other things remaining equal, the company supplying the product will have higher prices and higher margins. Conversely, if a company sells to a few large buyers, those buyers will have significant leverage to negotiate better pricing.

Some factors affecting buyer power are:

- Size of buyer ? larger buyers will have more power over suppliers.
- Number of buyers ? when there are a small number of buyers, they will tend to have more power over suppliers. The Department of Defense is an example of a single buyer with a lot of power over suppliers.
- Purchase quantity ? When a customer purchases a large quantity of a suppliers output, it will exercise more power over the supplier.

Supplier Power

Buyer power looks at the relative power a company?s customers has over it. When multiple suppliers are producing a commoditized product, the company will make its purchase decision based mainly on price, which tends to lower costs. On the other hand, if a single supplier is producing something the company has to have, the company will have little leverage to negotiate a better price.

Size plays a factor here as well. If the company is much larger than its suppliers, and purchases in large quantities, then the supplier will have very little power to negotiate. Using Wal-Mart as an example, we find that suppliers have no power because Wal-Mart purchases in such large quantities.

A few factors that determine supplier power include:

- Supplier concentration ? The fewer the number of suppliers for a given product, the more power they will have over the company.
- Switching costs ? suppliers become more powerful as the cost to change to another supplier increases.
- Uniqueness of product ? suppliers that produce products specifically for a company will have more power than commodity suppliers.

It?s important to analyze these five forces and their affect on companies we want to invest in. The Porter Five Forces Analysis will give you a good explanation for the profitability of an industry, and the firms within it. If you want to know why a company is able, or unable, to make a decent profit, this is the first analysis you should do.

Short note about the author

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