

Critical analysis of porter's 5 forces



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Essay Question: Critically discuss Porter's 5 forces model and argue whether the model still has relevance for today's modern business environment.

Introduction

“ Strategy is defined as the act of establishing a business direction that will successfully lead an organization into profit” (Kaplan and Norton, 1996).

Kaplan and Norton (1996) argue that the focal point of strategy formulation is how to effectively draw on business intelligence acquired from an organisation's internal and external environment. An organization's unique capabilities, resources and processes are considered its core competences. These core competences determine the organization's unique position against its competitors within its external business environment (Prahalad and Hamel, 1990).

The first step towards analysing an organization's position within a business environment is to consider an overview of the surrounding environment. Such an analysis, identifies the general factors that impact on all market segments that operate under the same economic, technological, political and social environment (Daft, Sormunen and Parks, 1988). While knowledge of these factors provides an indication of the extent that these forces can impact on an organization, a more narrow approach is vital to assess the immediate competitive environment.

Porter's five forces model (1979) was introduced as a strategy tool aiming to analyze the immediate competitive environment of individual industries. Having been developed as an industry analysis framework, the five forces model, considers the specific forces that determine competition. The impact

of these five factors facilitates the competitiveness and economic potential of an industry.

This paper aims to critically discuss the model starting with a detailed overview of the framework. Further research and critical evaluation of the theory on whether it still applies into modern business environment will also be considered.

Analysis of the 5 forces framework

An industry is described as a cluster of organizations sharing the same characteristics and competing in the same business environment (Lummus, Krumwiede and Vokurka, 2001). As industries share the same characteristics, the need to create a strategy tool that would enable the assessment of their profit potential, the impact of underlying drivers and their investment attractiveness was identified.

In 1979, Porter recognised this need and proposed a framework which analyses the basic structure which can be extended to every industry. This foundation, constitutes of five essential factors that summarise the most important criteria to consider in order to analyse a particular sector's key drivers of success. Based on such an analysis, a strategy can be formulated proposed on growth factors and certainty rather than scenarios and forecasts.

The first force of Porter's framework refers to the threat of entry and is concerned with the ease or perplexity to enter a particular industry. It should be clear that when an industry is difficult to enter, competition is high and existing competitors are very strong. Once potential newcomers decide to

enter such an industry, they will not pose a significant threat to existing competitors as they will rather need to overcome existing barriers. Typically, these barriers fall under a set of factors including economies of scale, product differentiation, capital requirements, cost disadvantages independent of size, access to distribution channels and legal constraints. Understanding how these barriers influence access to an industry is important to distinguish the competition level and profitability. For most industries, if the above factors do not constitute significant entry barriers a high threat of new entrants will be imposed (Porter, 1998).

The second force considers the threat of substitutes as competitive goods that may replace or complement an organization's offerings. Substitutes, are differentiated from the core product or services that the main competitors within the industry offer. However, they are still categorised as a competitive force as existing customers may switch to them and create an impact on the industry's market share and profitability. Where substitutes offer considerable performance advantages for their price value (price/performance ratio) and are developed by powerful and viable industries, they should be considered a serious competitive factor.

The third force discusses the power of buyers referring to the bargaining ability of customers to control a producer's or supplier's profitability. This is the case in industries where buyers can exert strong influence to suppliers or producers which ultimately shapes the competitive environment. There are several criteria that determine buyers power. It may be the concentration of power within a small number of dominant customers and when it is easy to switch to another supplier within the industry as their product offerings are

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not highly differentiated. Additionally, it may consider the buyer competition threat when customers use the purchased good as a production resource for their business. When buyers have the ability to produce the same product or resources themselves instead of buying it from the suppliers, their power is also significant. Also, if buyers buy large volumes of products and are sensitive to lower prices their power is high (Porter, 1998). .

The fourth force moves on to the power of suppliers and illustrates how dominant suppliers can reduce organizations power in negotiation for purchasing essential resources and their profitability. Increased supplier power is determined by a number of factors. These factors include concentration of power to a small number of suppliers. This poses challenges for organizations as they will be highly dependent to buying from these suppliers. Furthermore, they will face a significant switching cost if they decide to change supplier. Where a limited number of suppliers exist within a particular industry, it is considered a very profitable segment. Additionally, suppliers power is determined by their potential to integrate forward meaning the danger to cut out buyers and reach end consumers directly.

The fifth force concludes with the competitive rivalry which describes how the other four powers interrelate and shape the structure of competition within an industry. Putting together the impact of these forces, the level of competition as well as the profit potential and overall attractiveness and performance of an industry is determined. There are certain factors by which competitive rivalry is directly affected. If competing organizations are of approximately the same size, competitor balance will be such that rivalry will be intense. When industry growth rate is low, rivalry is likely to be intense.

The existence of high fixed costs to operate in the industry and high exit barriers if a firm wishes to leave the industry will also trigger high rivalry. Additionally, when there is not significant differentiation between the product offerings of individual competitors, the level of rivalry will also be intense.

Critical evaluation of the framework

Porter's five forces model is a classic strategic business tool deployed at industry competition analysis, to assess the prosperity capabilities and environmental influences. However, as industries are dynamic and business characteristics constantly evolve it may be questioned if it is still applicable and reliable (McGahan, 2000).

Criticism on whether the framework is incomplete suggests that the multi-level nature of certain industries may affect the accuracy of analysis. Specifically, as discussed in Johnson, Scholes and Whittington (2009) understanding that most industries may need to be analysed at different segments is vital in order to implement a coherent analysis. Referring to the multiple clusters within airline industries as a relevant example, the authors discuss that a successful industry analysis should be applied into each customer segment and market cluster in order to provide a concise picture not just an overview.

The dynamic nature of industries is identified as another underlying factor that may cause uncertainty about the suitability of the framework. The fast pace that industries change, may affect fundamentally the circumstances, individual capabilities and overall business environment. This process is defined as convergence and describes how dynamic changes may recreate

the industries causing two previously separate industries to merge (Van den Berghe and Verweire, 2000). More specifically, changing circumstances in converging industries may embed such resources innovations (for example technologies) that will enable new product capacities and ultimately widen competition (Malhotra and Gupta, 2001).

Bringing together products or services so that they complement each other, may create a powerful way to impose a new competitive force within an industry. Reflecting on complementary products and the potential to combine and reposition them so that they will cooperate rather than compete to each other, Burton (1995) emphasises how this can reshape industry competition. Similarly, ul-Haq (2005) discusses a different approach which suggests that complementary products develop significant business opportunities and initiative for organizations for cooperating rather than competing with each other as the five forces theory suggests. This approach determines an additional competitive force that may provide significant profit potential and competition insight (Brandenburger and Nalebuff, 1995). Hence, it is suggested to be placed as the sixth force to complement the five forces framework (Yoffie and Kwak, 2006).

The discussion so far has tended to assume that the five forces framework manages to address critical competition forces within an industry, although several other factors may also be considered in order achieve greater accuracy. In a relevant research, Christensen (2001) supports the value of the framework into the modern business environment. Christensen's (2001) conclusion is that the five forces framework is an essential strategy tool which can provide a useful insight into all organizations. Even though it is <https://assignbuster.com/critical-analysis-of-porters-5-forces/>

acknowledged that profit circumstances may vary across industries and thus the model can be developed further, it is still considered a sound basis for competitive analysis.

Similarly, Grundy (2006) outlines that there is still room to improve the framework and enhance its practical value. It is suggested that the five forces framework has been historically used as a theoretical strategy model with significant influence in mostly academic business management contexts. The author's approach relates with how it can be practically applied into the modern business environment with success. This includes several features including rating the impact of forces and assigning them an importance weight in order to explore how they interrelate and how they create an industry pattern.

An attempt to revise the application of the framework in today's business contexts should ensure that it manages to incorporate the prevailing circumstances of the era into the analysis. Considering that Internet has become an increasingly powerful factor, Karagiannopoulos, Georgopoulos and Nikolopoulos (2005), attempt to study if this traditional theory is still appropriate for current industry examination. Their findings support the studies discussed above acknowledging the value of the framework as the starting point of competition examination. However, they also stress the influence of several other facts relative to technology innovation and the profit capabilities these create in order to accurately diagnose the changing nature and new patterns of economy and industries. The potential to utilise the five forces framework as the foundation of technology and Internet competition analysis is also confirmed by Siaw and Yu (2004).

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Conclusion

Porter's five forces model has been a very influential strategy framework providing guidelines to investigate competition, profitability and investment attractiveness within an industry. The purpose of this paper was to discuss the value of this traditional strategy framework into modern business environments. Providing a detailed examination of the individual five forces, the process of competitive industry analysis was explored.

The very process of determining the optimal strategy following the principles of the model was identified. This relates to an assessment of the level of intensity of the individual five forces being the threat of entry, the threat of substitutes, the power of buyers, the power of suppliers and the competitive rivalry between them.

Extending this principle into subsequent analysis and evaluation of the framework, more recent research was considered. Major conclusions signify that the defining characteristics of the framework can still be applied with success into strategy and modern business practices. However, good decision making practices should include a set of parameters to obtain a complete and up-to date picture. These parameters are based on the notion that industries are dynamic environments and changing factors directly affect competition as they impact on each competitor's capabilities and profit potential. The most crucial to be included in a relevant analysis are then defined as technological innovation and advances, mapping of individual market clusters within industries, convergence and the potential to complement and reposition products.

Overall, current strategy research follows Porter's five force's framework in competition and industry analysis. The framework is found to be of critical importance in building strategic decisions. A more practical and realistic approach is nevertheless required in order to achieve a less vague and contemporary picture.

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