Transcript for The Five Forces Analysis Explained Video

**Introduction**

The Five Forces Analysis

Michael Porter of Harvard Business school developed the five forces model as a tool to analyze the competitive environment in industries. He argued that some industries are consistently more profitable than others and that by analyzing the competitive environment you can see which industries are attractive for companies to compete in. For example, he found that airlines tend to be unprofitable whereas soft drink companies are highly profitable, and the five forces model can be used to explain why this is the case.

**Five Forces Analysis**

The framework considers five factors that drive competition in an industry. Let's discuss each one in turn and illustrate with an analysis of the coffee shop industry in a typical city.

The first force is the level of rivalry. Having lots of strong competitors in an industry who are all fighting for customers will make life difficult. Many cities now have lots of coffee shops making the level of rivalry high. This by itself makes the industry not very attractive. In the five forces model it is recognized that you are not only competing for profit with your direct rivals but also with customers, suppliers, substitutes and potential entrants.

If customers tend to be large and they can easily switch between suppliers they are in a strong position to negotiate lower prices which will limit industry profitability. In the coffee shop industry customers tend to be individuals who cannot negotiate the price of the product. However, the fact that they can easily switch from one supplier to another as well as their ability to leave reviews on social media increases their power.

Similarly, if suppliers are strong and offer unique products that companies in the industry cannot go without the industry will be less attractive. For coffee shops, suppliers of coffee beans milk and sugar are not powerful since there is a lot of choice and switching from one supplier to another is easy.

The fourth force in the model is the power of substitutes. Coffee shops don't only compete against each other but also against products in other industries that satisfy a similar need. For example, if you do not get your drink from a coffee shop you might make it at home or get it from a machine. If these products are seen as good substitutes for coffee shops then this limits profitability in the industry. In reality, many people see coffee shops as a place to meet friends or take a short break out of the house and there are not many good alternatives that meet these needs.

Finally, the threat of new entrants can make an industry less attractive. Entry barriers in the coffee shop industry are low and it is quite easy to enter the business. This means that a coffee shop owner does not only compete against existing rivals but also against other potential competitors who may enter the industry at any time. Other industries, such as car manufacturing, are more difficult to enter and companies know they will not suddenly face lots of new competitors.

**Barriers to Profitability**

By considering each of the five forces and then looking at the total picture it is possible to make conclusions about how attractive an industry is. Carrying out a five forces analysis also helps to identify the barriers to profitability in an industry and enables companies to design strategies that deal with these barriers. For example, if customers find it easy to switch between different coffee shops then a company can introduce loyalty cards to encourage customers to keep coming back. Similarly, if the level of rivalry is strong, companies can try to differentiate in order to provide unique value to customers and make the competition less of a threat.

**Step-by-step approach**

If you do a five forces analysis the best is to take a step-by-step approach as follows.

1. Define the industry that you are analyzing
2. For each force identify the current situation. Who are the most important competitors, customers and suppliers? What are the substitutes and entry barriers?
3. Analyze the attractiveness of the industry for each of the five forces. For each force are there factors that make the industry easy or difficult for companies?
4. Finally, look at the overall picture and consider what your analysis as a whole says about the attractiveness of the industry and about how to successfully compete in it.

Remember that even if your analysis shows that an industry looks unattractive it is still possible to be profitable with an innovative and original strategy. There are lots of examples of successful companies in difficult industries.

That concludes the five forces analysis. Check our other videos for more insights. Brought to you by SIM institute.