GCE BUSINESS

A level Component 2
Porter's Five Forces (1)

Objectives:

1. Define Porters Five Forces theory
2. Explain each of the five forces
3. Explain the factors which determine the force
4. Conduct a P5F analysis

Further reading: Hall and Jones 602-621

Spec: Porters Five Forces Framework (Strategy & Tactics)

Starter questions - Recap

1. Outline the key stages of the decision making process.
   Mission, Objectives, Strategy, Tactics

2. What tool is used to help identify the internal and external factors which should be considered during decision making?
   SWOT

3. Identify three internal stakeholders
   Managers, employees, shareholders

4. Identify five external stakeholders
   Competition, government, suppliers, customers, local community

5. What are the two categories of risk?
   Quantifiable and unquantifiable

Pre-reading to be completed by:

Porters 5 Forces

Porter proposed a model of the business environment that pictured industries and firms as being influenced by five forces. He put forward the idea that the interaction and influence of these 5 forces will determine the likely levels of profitability for a firm within a particular industry.

Business owners and managers can use this model of five forces, to better understand the industry in which the firm operates, and properly consider the external influences on the firm's behaviour. Once they have this understanding managers will be able to devise appropriate strategies, showing how to maximise profitability. Understanding of the Porters Five forces will also demonstrate to owners and managers that there are limits on what can be achieved, and therefore how to set realistic objectives.

Force 1.Barriers to Entry – factors that prevent new competition entering the market. If these are strong then monopoly profits can occur. Weak then only normal profits can be earned. Examples include:

- Cost advantages of existing firms.
- Access to factors of production e.g. raw materials, skilled staff, and components.
- Government policy – govt. created monopolies, licensing, regulation.
- Economies of scale—these reduce average costs of production, making it difficult for new entrants to compete.
- High capital/ investment requirements.
- Strong Brand identity of existing firms products
- Access to distribution networks
- Predictable behaviour of existing firms e.g. retaliation through short term pricing strategies.
- Access to technologies used in the industry.

Force 2.Supplier Power – higher the supplier power, the lower the potential for profits. If suppliers have high levels of power they are able to push up prices for raw materials and components, so lower profit margins for the buyer. On the other hand with lower levels of supplier power, the situation is reversed, the buyer may be able to force prices paid for components and raw materials down, so higher profit margins for the buyer.

Examples of factors that determine supplier power include:

- The number of alternative suppliers— competition amongst suppliers.
- Importance of volume to supplier
- If inputs make up a large proportion of costs
- If inputs (raw materials or components) help create differentiation of product made.
- The costs of switching to a new supplier
- Availability of alternative (substitute)
- Inputs

Force 3. Buyer Power— in this case we consider the influence of the end user of the product, the buyer. The higher the buyer power, lower the potential for setting price and increasing profits. But of course the lower the buyer power the more control the supplier firm has over price and profit margins,

Examples of factors that determine buyer power include;

- The amount of bargaining leverage the buyer has. For example are the buyers the major distributor on the market?
- Buyer volume—are they buying in bulk? The larger the order the great the level of negotiated discount
- Whether the buyer has information on costs / availability of alternative suppliers.
- Brand identity and loyalty of the product bought. If the product is branded they buyer has less control over price paid, they may even be told the price that they can sell the product at.
- Price sensitivity of the product—how changes in price affect demand levels.
- Threat of take-over by customers.
- Availability of substitutes – can the buyer buy from elsewhere?

Force 4. Degree or level of Competition in the market. –the level of competition in a market can in theory vary between a pure monopoly to perfect competition. As a general rule we can say the lower the level of competition the higher the profit margins.

Examples of factors that determine the numbers of competitors in a market include;

- The level of collusion in the market—do the firms act together to control price and share out the market between them?
- Maturity of the market—is the market stable with established brands and market leaders, or is the market immature, with new entrants being able to join.
- Industry concentration—is the market a monopoly, or an oligopoly with a few firms dominating the market, or even more like perfect competition with many firms having small market shares.
- Product differentiation in the market. Is the market full of virtually identical products (soap powders), or are the products identifiably different (car market).
- Strength of brands in the market, levels of brand loyalty. Are customers easily tempted to switch brands.
- The existence of patents and licenses to operate in the market. Patents can give companies monopolies of production of specific products, and licences offered by governments or regulators will limit the numbers of competitors.

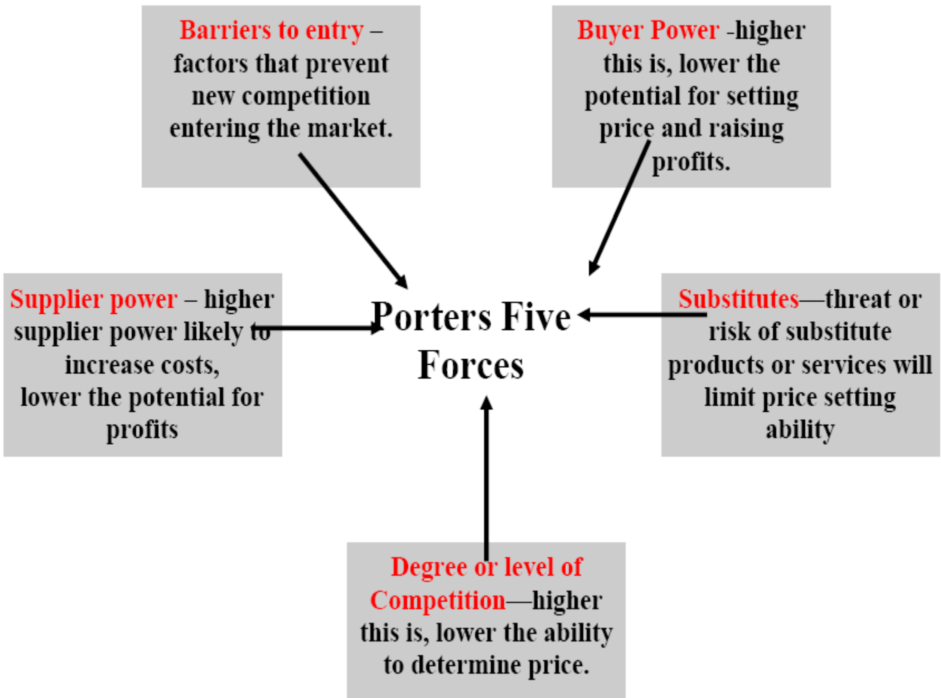
Force 5.Threat or risk of substitute products or services —when there is the possibility of buyers switching to an alternative product, then behaviour of the supplier firm will always take this in consideration.

Examples of factors that determine the likelihood of availability of substitute products include:

- Rate of change of technology—fast the rate of change of technology, more quickly substitutes are likely to occur
- Availability of capital for investment— are potential producers of substitutes likely to be able to raise the capital required for R and D and production
- Switching costs for customers—cost of changing to substitute. Level of substitution effect—how close is the substitute, how easily does it replace the original product or service.
- Price-performance trade-off of substitutes—how effective are the substitutes cost and performance wise, for example at the moment electric cars do not offer an effective substitute for petrol engine cars so few people consider them as effective substitutes.

Note any questions/queries you have after the pre-reading.

You have examples for each force in the pre-reading notes!



Porters 5 Forces

Porter proposed a model of the business environment that pictured industries and firms as being influenced by five forces. He put forward the idea that the interaction and influence of these 5 forces will determine the likely levels of profitability for a firm within a particular industry.

Business owners and managers can use this model of five forces, to better understand the industry in which the firm operates, and properly consider the external influences on the firm's behaviour. Once they have this understanding managers will be able to devise appropriate strategies, showing how to maximise profitability. Understanding of the Porters Five forces will also demonstrate to owners and managers that there are limits on what can be achieved, and therefore how to set realistic objectives.

Porters Five Forces task: delete as appropriate

- The interaction and influence of these 5 forces will determine the likely levels of profitability for a firm within a particular industry.
- Business owners and managers can use this model of five forces, to better understand the industry in which the firm operates, and properly consider the external influences on the firm's behaviour.
- The use of P5F can be used to identify opportunities and threats – which in turn can be used to formulate the PESTLE / SWOT

Barriers to entry

- Current firms will want barriers to entry to be high/low because this will help prevent new competition entering the market; thus the current firms can maintain its power over the market and consumers.
- With no new firms entering the market the business can have more/less control over the prices it charges and reduce the number of customers/substitutes for its products.
- Thus the higher the barriers to entry the higher/lower the likely levels of profitability.
- Factors that determine the barriers to entry for the industry are: (see reading notes)

Buyer power (remember this means 'customers')

- Firms will want buyer power to be low/high so that they have more flexibility in terms of the prices/costs they can charge without losing customers. The lower the buyer power the more price inelastic/elastic the product can potentially be.
- Thus the lower the buyer power the higher/lower the likely levels of profitability.
- Factors that determine the level of buyer power are: (see reading notes)

Supplier power (remember this means suppliers to the industry/business)

- Firms will want supplier power to be low/high so that suppliers need to maintain lower/higher prices, improve customer service, credit terms and generally work hard/less to keep the business as a customer.
- Lower supplier prices means lower costs/prices for the firm which can either mean they make more/less profit or are able to decrease/increase their own prices to increase/decrease demand for their goods / services.
- Thus the lower the buyer power the higher/lower the likely levels of profitability.
- Factors that determine the level of supplier power are: (see reading notes)

Degree or Level of Competition (careful <u>not</u> to confuse with substitutes!)

- This relates to the competitive nature of the industry. For example, are there lots of competitors or very few. More importantly it considers the level of ‘power’ or ‘strength’ these competitors have in the market.
- Links can be made to Market Structures (BS1) – Monopoly, Oligopoly, Monopolistic Competition and Perfect Competition.
- Firms will want the level of competition to be low/high because this will mean they have more/less power within the market. Therefore, they have more/less flexibility in terms of the price they can charge, will require less/more promotion and generally have to work less/more to keep or gain customers.
- The lower the level of competition the higher/lower the likely levels of profitability.
- Factors impacting the level of competition: (see reading notes)

Substitutes (remember this means suppliers to the industry/business)

- This relates to how easily their customers can switch to alternative products (e.g. substitutes).
- Firms will want there to be fewer/more substitutes so that they do not need to compete as much in terms of reducing prices, increasing promotion, etc..
- The more substitutes there are for the firm’s goods the harder/easier they have to work to convince customers to buy from them, e.g. lower prices, advertising, etc..
- Firms spend a lot of money on branding which is essentially trying to reduce/increase the number of ‘acceptable’ substitutes for their product. For example, Nike use ‘branding’ to convince customers that whilst other trainers are available none are as good (and therefore can substitute) Nike trainers.
- The availability of substitutes will be determined by: (see reading notes)

Extension – can you identify business / industry examples for the factors determining the levels of each force?

Plenary activity:

Summarise the ideal scenario for a firm in relation to Porters Five Forces Framework:

Force	Best scenario	Justification (be specific)
Barriers to entry	High	
Buyer power	Low	
Supplier power	Low	
Threat of substitutes	Low	
Degree / level of competition	Low	

Formal assessment:

You have not completed enough of the specification to complete a BS3 past paper (other than the ratios)

WHSmith – June 2010

Teacher guidance on completing a BS3 paper:

- Scan the question first
- Highlight and annotate the case study
- As you are reading through make notes of relevant terminology / syllabus links
- Watch time

Group activity:

Teacher note give each group a different firm (e.g. Aldi, Sainsburys, Apple, Cadbury, McDonalds, Easyjet, etc..)

In groups complete a porters five forces analysis using the diagram.