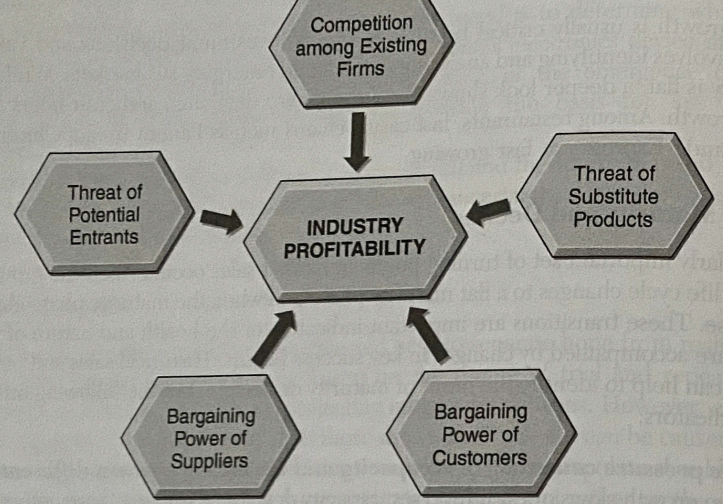

Figure 4.3 Porter's Five-Factor Model of Market Profitability

Source: Michael E. Porter, *Competitive Advantage*, New York: The Free Press, 1985, Chapter 1.

Porter's approach can be applied to any industry, but it also can be applied to a market or submarket within an industry. The basic idea is that the attractiveness of an industry or market as measured by the long-term return on investment of the average firm depends largely on five factors that influence profitability, shown in Figure 4.3:

- The intensity of competition among existing competitors
- The existence of potential competitors who will enter if profits are high
- Substitute products that will attract customers if prices become high
- The bargaining power of customers
- The bargaining power of suppliers

Each factor plays a role in explaining why some industries are historically more profitable than others. An understanding of this structure can also suggest which key success factors are necessary to cope with the competitive forces.

Existing Competitors

The intensity of competition from existing competitors depends on several factors, including:

- The number of competitors, their size, and their commitment
- Whether their product offerings and strategies are similar
- The existence of high fixed costs
- The size of exit barriers

The first question to ask is, how many competitors are already in the market or making plans to enter soon? The more competitors that exist, the more competition intensifies. Are they large firms with staying power and commitment or small and vulnerable? The second consideration is the amount of differentiation. Are the competitors similar or are some (or all) insulated by points of uniqueness valued by customers? The third factor is the level of fixed costs. High fixed-cost industries such as telecommunications and airlines experience debilitating price pressures when overcapacity gets large. Finally, one should assess the presence of exit barriers such as specialized assets, long-term contract commitments to customers and distributors, and relationship to other parts of a firm.

One major factor in the shakeout of the Internet bubble firms was the excessive number of competitors. Because the barriers to entry were low and the offered products so similar, margins were insufficient (and often nonexistent), especially given the significant investment in infrastructure and brand building that was needed. Given the fast market growth and the low barriers to entry, these results should have been anticipated; at one time there were a host of pet-supply and drugstore e-commerce offerings competing for a still-embryonic market.

Potential Competitors

Chapter 3 discusses identifying potential competitors that might have an interest in entering an industry or market. Whether potential competitors, identified or not, actually do enter depends in large part on the size and nature of barriers to entry. Thus, an analysis of barriers to entry is important in projecting likely competitive intensity and profitability levels in the future.

Various barriers to entry include required capital investment (the infrastructure in cable television and telecommunication) and economies of scale (Becton Dickinson's 80 percent market share in the blood collection category means that R&D investments are spread over a large number of units making it difficult for competitors to enter). Likewise, barriers to entry can include distribution channels (Frito-Lay and Texas Instruments have access to customers that is not easily duplicated) and product differentiation (Apple and Harley-Davidson have highly differentiated products that protect them from new entrants).

Substitute Products

Substitute products compete with less intensity than do the primary competitors. They are still relevant, however, as the discussion in Chapter 3 made clear. They can influence the profitability of the market and be a major threat. Thus, plastics, glass, and fiber-foil products exert pressure on the metal can market. Electronic alarm systems are substitutes for the security guard market. E-mail threatens some portion of the express-delivery market of FedEx, UPS, and the U.S. Postal Service. Substitutes that show a steady improvement in relative price/performance and for which the customer's cost of switching is minimal are of particular interest.

Customer Power

When customers have relatively more power than sellers, they can force prices down or demand more services, thereby affecting profitability. A customer's power will be greater when its purchase size is a large proportion of the seller's business, when alternative suppliers are