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Porter's five forces framework is one of the several strategic analytical tools that organisations should consider using to better understand their industry's environment (Callahan et al. 2004). Porter's five forces framework concentrates on an organisations' industry and its characteristics to assess the competitive dynamics (Porter, 2004). Porter (2004) identified five forces which shape industries' competitive landscape; these include the risk of entry by potential competitors, the bargaining power of customers and suppliers, the threat of substitutes and the internal rivalry between incumbent firms. While these forces are separately discussed, they are by no means independent (Grundy, 2012). The relative strength of each force influences other forces too and ultimately firms' ability to earn profit and to raise prices in their industry. Even though the model is still widely used, it has been criticised on the ground that it cannot accurately reflect reality (Randall, 2008). Alongside a critical analysis of the factors that determine each force's strength in an industry, the limitations of the models are also addressed by the essay.

Threat of New Entrants

Firms are interested in entering those markets that promise high returns (Markman and Phan, 2011). Generally speaking, firms should be careful entering highly competitive markets as competition erodes firms' profitability (Porter, 2004). Even though entering a new market is desired by many firms to grow, there may either be structural (e.g. economies of scale, access to resources, government policies supporting incumbent firms…etc.) or strategic (high switching costs, existing firms pricing practices, patents…etc.) barriers which reduce this threat (Landoli et al. 2007). In addition to that, firms must consider possible exit barriers too – if a firm cannot easily leave an industry (e.g. due to legal obligations or high investment in non-transferrable fixed assets), the sector will appear to be less attractive (Hitt et al. 2004).

Another factors influencing the risk of entry include product differentiation, brand equity and customer loyalty (Porter, 2004). With a low level of product differentiation, new entrants may find it difficult to convince customers to purchase their products or services. This is especially true if there are established powerful brands in the industry with a loyal customer base, so new entrants have a limited opportunity to convince customers to switch (Keller, 2013). Customers' tendency to switch between sellers is dependent on the size of their switching cost (any cost incurred from switching from one company to another) (Hitt et al. 2004). In some industries, organisations deliberately lock-in customers through fixed-term contracts to intentionally reduce this force (Porter, 2004).

Bargaining Power of Customers

Under certain conditions, customers could influence firms to provide higher quality products and lower prices (Daft and Marcis, 2010). If buyers are concentrated (i.e. few buyers) but there are many sellers in the industry, buyers' ability to influence firms is stronger, since firms' cost of losing one customer could be quite significant, thus sellers are naturally interested to consider buyers' requests (Porter, 2004). On the contrary, if there are only a few sellers but many buyers, firms possess stronger bargaining power over customers. Essentially, to measure the bargaining power of customers, it is worthwhile to compare buyers' switching cost to firms' relative switching cost to understand if indeed customers are in a stronger bargaining position (Quinn et al. 1988).

The degree of information availability (transparency) also supports buyers' bargaining power (Porter, 2004). If firms cannot hide information from customers or if customers could easily compare (e.g. through the internet) sellers' offers, buyers possess a strong bargaining power. However, this only holds true if there are close substitutes available for a particular good or service. If buyers are heavily dependent on one seller (e.g. in case of highly customised inputs), they cannot significantly influence producers (Porter, 2004).

Bargaining Power of Suppliers

The group of suppliers include those companies that provide sellers with raw materials and various other inputs (e.g. labour) (Dyck and Neubert, 2010). When this force is considered, firms' are acting as buyers on the market of inputs, so the situation is somewhat similar to customers' bargaining power, with only a few differences (Porter, 2004). The role of switching cost is similar; firms and suppliers' relative switching cost mainly influences this power. If the inputs are differentiated

(i.e. specific) and only a few suppliers could satisfy firms' need (i.e. inputs cannot be substituted), suppliers enjoy a high bargaining power. However, if a high number of substitute inputs are available, suppliers cannot extort much influence on firms. The presence of labour unions could also influence firms' bargaining power, since unions through the collective representation of employees (a kind of input without any close substitute in the short-term) could pressure firms (Hitt et al. 2004).

Finally, in some cases, firms may decide to vertically integrate to avoid suppliers (e.g. firms could start producing their raw materials in-house) (Hitt et al. 2004). This move could be quite expensive in many industries, nevertheless firms' ability or tendency to vertically integrate in an industry is also worth considering whenever this force is discussed.

Threat of Substitutes

It is very rare that for a particular service or good there is no substitute, so organisations must consider how buyers could potentially purchase from another sellers and whether or not there is any method to reduce their products' substitutability (Davis et al. 2001). By definition, a substitute is a product or a service that offers similar benefits to customers (Porter, 2004). Close substitutes influence firms' ability to generate profit and to raise prices, as substitutes reduce the demand for the products being substituted. As it was suggested in the introduction, the forces are interdependent, so this force is also influenced by buyers' tendency to substitute (e.g. price sensitivity), switching cost and brand loyalty (Hitt et al. 2004). It should be mentioned that substitution could be a rather subjective concept – some costumer may perceive a product to be a perfect substitute for another (e.g. apples to oranges), while some may have higher expectations for substitution (i.e. the perceived level of substitution) (Dyck and Neubert, 2010).

Generally, the average customer would first review the price of the substitute product – if the substitute product is cheaper, buyers may be more inclined to substitute (Hitt et al. 2004). Whilst a qualitative comparison between products/services is sometimes difficult, if customers perceive the substitute to be of equal or higher quality, the threat of substitutes will increase (Porter, 2004).

Internal Rivalry

Finally, internal rivalry describes the extent to which incumbent firms limit each other's profitability in the industry (Porter, 2004). The degree of internal rivalry is determined by the previous forces described. If these forces are strong, internal rivalry is assumed to be intensive, meaning that incumbents will engage in fierce competition and will realise lower profit figures. This force should inform firms about the viability of their entry to a particular industry as engaging in competition is both expensive and risky (Markman and Phan, 2011).

The degree of internal rivalry is mainly determined by the number of competitors (i.e. incumbent firms), the growth rate of the industry, the proportion of fixed costs and buyers' tendency to switch (Porter, 2004). If there is high number of firms with similar strategic profiles and products (little differentiation) in a maturing (or even declining) industry, incumbents will eventually encroach on each other's market share, so competition is unavoidable. This combined with a high proportion of fixed costs, exit barriers and a consequent limited ability to adjust capacity in small increments intensifies internal rivalry (Hitt et al. 2004).

Limitations

Porter's model has received a series of criticism due to its inability to accurately reflect reality (Randall, 2008). First, the model is probably too superficial to guide firms' competitive actions in their industry. The model examines industries at their highest level of analysis, so the different industry segments and general markets are disregarded. This means that the analysis is too broad and therefore lacks the necessary focus to assist organisations in their strategy formulation. Second to this, Porter's model describes a static environment and provides only a snapshot view of an industry (Schmidt, 2010). Strategic planning concerns long-term objectives and evidently the five forces analysis does not discuss the consequences of the changes in industries, therefore the model is only relevant for short-and perhaps medium-term decisions. Third, the model assumes that firms' competeviness is only dependent on market forces, however, in reality, economic, political, social and environmental factors (non-market forces) could also shape industries and their competiveness (Hill et al. 2004). Therefore, the five forces framework alone cannot be adequate to analyse an industry due to its inherent limitations.

Conclusion

The five forces model describes an industry's environment at a particular point in time, so it is suitable for firms to assess whether or not (assuming a constant environment) entering a new industry is an economically sound idea. The model encapsulates suppliers, buyers, substitute products and the threat of new entrants to establish the degree of competition within an industry. The strength of the model is that it comprehensively analyses those factors that shape an industry's profitability, so firms' can approximate the characteristics of an industry with this model. However, a sole reliance on this model is not recommended for strategic decision-making due to its short-term focus. As previously mentioned, the model is perfectly appropriate to describe an industry "as it is", yet the model does not consider how particular changes over time could influence the relative strength of each force.

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