

## 5.1.2: Porter's Five Forces

Whereas financial statements are a standard method of organizing facts about a firm of interest to owners, regulators, tax collectors, and other stakeholders, no equivalently standard method of organizing facts about the environment of a firm is available. The closest to a standard method may be Michael Porter's (1980) Five Forces. Porter groups the reasons for the relative successes of industries into five categories that he calls forces. These forces include two powers of closely related industries, two threats from unrelated parties, and relationships among competitors in the industry. The forces are (a) bargaining power of buyers, (b) bargaining power of sellers, (c) threat of new entrants, (d) threat of substitute products or services, and (e) rivalry among competitors. Porter's adapted schematic drawing of the five forces is shown in Figure 5.1.2.2

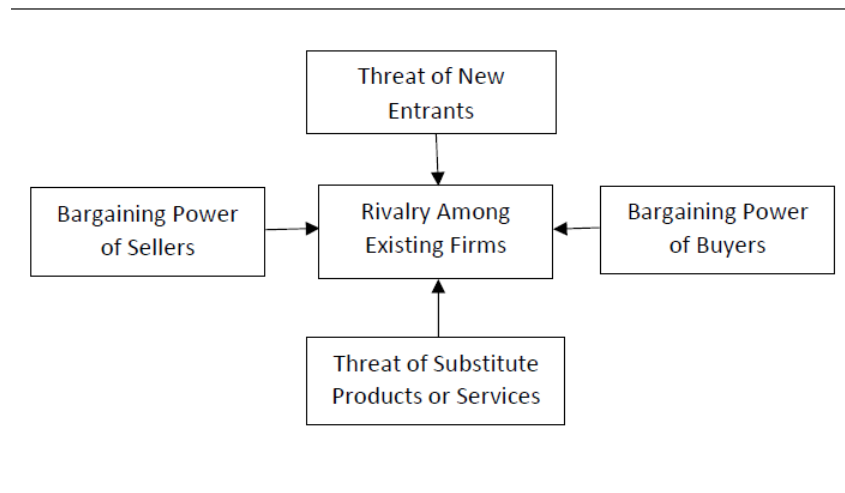


Figure 5.1.2.2 Porter's Five Forces

### 5.1.2.1: Bargaining Power of Buyers

The bargaining power of buyers refers to the bargaining power of a firm's customers. This force favors the industry when the buyers of its products are many, for the intensity of the competition among buyers rises with their number, which reduces their bargaining power in dealings with their suppliers.

### 5.1.2.2: Bargaining Power of Sellers

The bargaining power of sellers refers to the bargaining power of a firm's suppliers. This force favors the industry when sellers of the resources it needs are many, for like buyers, the intensity of the competition among sellers rises with their number, which reduces their bargaining power in dealings with their customers.

### 5.1.2.3: Threat of New Entrants

The threat of new entrants is the ease by which new companies can join the industry. The new entrants may initially expand the market for a new industry by helping to publicize the benefits of the industry's products, but as the market approaches saturation, new entrants cut into the market share of the established companies. In the long-term, costly entry bolsters the profitability of the industry. Thus, this force favors the industry when the cost of entry, comprising required fees and necessary investments, is high.

### 5.1.2.4: Threat of Substitute Products or Services

Even when the power of buyers is weak, the availability of substitutes for the products of an industry limits the prices that can be charged for the products. Threat of substitution favors the industry when good substitutes are not available or available at high prices only.

### 5.1.2.5: Rivalry Among Existing Firms

Besides industry structure and culture, the extent to which existing firms of an industry try to outcompete each other depends upon their numbers. Rivalry increases with the number of competitors, so this force favors the industry when the number of competitors

is small.

### 5.1.2.6: Applying the Five Forces

In the absence of numbers, Porter's Five Forces is applied by using judgment to interpret available facts. Judgments differ, so one person might conclude that a force is favorable to the industry, whereas another person examining the same facts might reach a different conclusion. The disagreements should be explored to see if they arise from resolvable differences in knowledge or understanding. Unresolved disagreements at the solution-evaluation stage call for applying Screening Principle #2: Solutions supported by facts or interpretations of facts that are challenged by other members of the group should be rejected.

Essentially, Porter's Five Forces is a checklist of items to study about the environment of a business. The checklist assures that all bases are covered. The primary value of the checklist is in the learning that occurs as the items of the list are discussed and debated, with the completed list itself having only a modest value in assisting memory of issues considered. What truly matters is the quality of the strategy, not the quality of the list. In other words, participants in a five-force discussion should see it as an opportunity to learn more about the firm, rather than an assignment to develop a quality list.

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