A Critical Analysis of Porter's 5 Forces Model of Competitive Advantage

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Abstract

The 5 forces of competitive advantage, as outlined by Porter, attempt to explain how firms can achieve Competitive Advantage in the industry they belong too. While this theory is certainly applicable to a fair degree, it is not free from its limitations.

This paper critically analyses the Porter's 5 forces model while also comparing it with various other frameworks that attempt to explain Sustainable Competitive Advantage. It goes on to show the progress of tools used by management theorists to understand the importance of (sustainable) competitive advantage. This is done with the help of models that comprise of both the industry-based view, such as Porter's 5 forces, and the resource-based view, such as Barney's VRIN framework. The progress this paper looks at also includes relatively more revolutionary views and perspectives from thinkers like Grundy and Recklies.

The paper broadly covers the explanation of the five forces with a few examples, after a short introduction, prior to examining the advantages and disadvantages of the framework. Here the paper outlines various other frameworks that suggest means of overcoming a few of the limitations highlighted in Porter's model. This includes the work of authors like Barney, Hamel & Prahalad, Teece et al., Penrose and various other esteemed management theorists. The paper finally concludes with the view on Porter's framework highlighting the most significant merits and demerits.

Introduction

The five forces model of competitive advantage proposed by Michael Porter posits a compelling view on how a firm can achieve competitive advantage in a particular industry by leveraging on five imperative forces of the industry.

This modern theory of competitive advantage, while being widely renowned, and accepted, is certainly not free of its flaws. The following essay critically analyses the framework presented by Michael Porter on Competitive Advantage.

The five forces are comprised of factors that could affect the positioning of a firm in a particular industry, this includes The Bargaining power of Buyers; The Bargaining power of Sellers; The Threat of Substitutes; The Threat of Potential Entrants and; The Threat of Existing Competition. The relative importance of a threat depends from industry to industry.

Bargaining Power of Buyers

This refers to the powers exerted by buyers on the firm. In certain industries, buyers exhibit high bargaining power, such as if the industry has a small number of buyers who purchase large volumes, these are particularly powerful in industries with high fixed costs. Buyers are also powerful in instances where industry products are homogeneous, and when the buyers do not face high switching costs. If vendors portray symptoms of high profitability, the buyer can integrate backwards and produce the industry products themselves (Porter, 2008).

The power of buyers can be negated by raising the switching costs for the buyer, by inculcating loyalty towards the brand or by differentiating the products, thus increasing the value-added and shifting the purchase decision to a product instead of a price-based decision. (Recklies, 2015)

Bargaining Power of Suppliers

Powerful suppliers can capture more value for themselves by charging higher prices, limiting quality or services, or shifting costs to industry participants. Powerful suppliers can squeeze the profitability out of an industry that is unable to pass on the cost in its prices, such as in the airline industry. (Porter, 2008).

Suppliers exhibit high power, when they are few in number, offer differentiated products, and can credibly threaten to integrate forward in the industry. A firm can tackle them by integrating backwards or by outsourcing their requirements.

Threat of New Entrants

Some management thinkers argue that this is potentially the most daunting of the 5 forces, especially when the argument is posed in the modern globalised world, where barriers to entry are virtually negligible. New Entrants, put pressure on incumbents to cut prices, and thus profitability. Potentially, these new entrants can drive out entire companies out of the market (Porter, 2008) , as in the case of Apple and Nokia, where the latter no longer has a significant amount of market share in the mobile phones industry (1%) (Spence, 2018)

Some barriers to entry can be to raise customer switching costs through building brand loyalty, or by having unequal access to distribution channels in such a manner that prevents new entrants from achieving supply chain efficiency. Aggressive Marketing by cutting prices is another approach that a firm can take to void the threat of new entrants. Sometimes, the mere fear of a large incumbent taking this approach is enough to deter a new entrant from participating in the market.

Threat of Substitutes

The threat of substitutes refers to the competition that is created in the market by substitute products and when the buyer faces a choice between products that can potentially offer the same level of utility. For example, the substitute to a flight between London and Paris is the Eurostar train, it is cheaper and cost-efficient, therefore a large proportion of the population would tend to prefer the Eurostar over a flight.

The threat of substitutes is high when there is an attractive price-performance trade-off, or when the buyer has lower switching costs. This may seem fairly easy to remove but are quite complicated, as many-a-times, firms are not aware of all their potential substitutes. [Porter, 2008]

Existing Rivalry

The degree to which rivalry drives down an industry's profit potential depends, first, on the intensity with and, second, on the basis on which companies compete.

These tend to be high when there is slow growth, or when there are a large number of competitors. They may also occur in situations when firms may not be able to read each other' signals in the market. It is akin to the Game Theory- Prisoner's Dilemma Model, where cooperation is not plausible [Deng and Deng, 2014] where one firm's gain is another firm's loss. This threat can also be positive-sum, if each competitor increases targets different segments of the market [Porter, 2008].

Optimal Competitive Position as per the 5 forces

As per the Five forces model, Porter gives us an optimal positioning strategy by saying that the optimal position would be in a certain industry would be where there are high barriers to entry, where both suppliers and buyers have low bargaining power, where there are little or no substitutes, and no threat of potential entrants, and finally where the existing rivalry is low.

These are those companies that Merchant(2012) refers to as the 'big 800-pound gorillas' that dominate the industry through sheer size and control over the five forces.

Advantages of The Five Forces Framework

It focuses on an external analysis, moving away from the traditional SWOT approach, enabling a firm's focus to gravitate on its reaction to a change in the external environment. The five forces framework is also very inter-linkable with other models, such as the PEST forces [Political, Economic, Social, Technological] to help in understanding and leveraging on dynamism.

It also emphasised the importance of searching for imperfect markets which offer more opportunities, as imperfect markets create opportunities for supernormal profits, but this possibility does not exist in perfect competition.

The five forces framework, additionally, shows how competitive rivalry is the central idea and is very much the function of the other four forces, as the other four forces affect the industry and therefore even the competitors. [Grundy, 2006]

Grundy (2006) states that the Porter's 5 forces model went beyond a more simplistic focus on relative market growth rates in determining industry attractiveness.

Disadvantages and Criticisms

Porter, initially, completely ignored the effect of complements on the industry, while recognizing substitutes, for instance, the market for digital games is severely impacted with the introduction of a new gaming console such as a 'Microsoft Xbox' or a 'Sony Playstation'. While he mentions it in the revised edition, he states that 'they can be understood through the lens of the five forces', while many management theorists consider that to be a Sixth force [Wilkinson, 2013].

Porter also makes a very bold claim that 'Industry structure drives competition and profitability, not whether an industry is emerging or mature, high tech or low tech, regulated or unregulated.' (Porter, 2008). In many avenues, the industry structure may not be the only factor that influences the profitability of firms. Governments and legal action can also have major consequences on the profitability of firms.

An additional criticism by Grundy (2006) is that Porter oversimplifies industry value chains, in certain situations, buyers may need to be both segmented and differentiated between channels, intermediate buyers and end customers, for example in markets where the manufacturer both sells personally and has distributors. Porter does not specify which buyers are due greater importance and therefore their ranking in terms of priority. This can be critical in many industries as the distributor can eventually compete against the manufacturer, perhaps by selling a similar or even a competitor's product.

Another striking weakness in the model is that is a static one. It provides a snapshot of the wider industry at some point in the past [Beattie, 2018] and may be useful for developing short-term strategy, but in the modern-day, that is writhe with dynamism and constant changes, the model does not provide any additional advantage; and while the PEST Framework along with the Porters' Five Forces, does give us an idea into estimating dynamism, most of the latter is controlled by the PEST framework, which is highly linked to other frameworks as well, such as the SWOT analysis.

Merchant [2012], citing another criticism, calls the modern-day companies 'gazelles' that far outcompete the '800-pound gorillas' who follow the Porter's' five forces model of competitive advantages; stating that in the present world, firms need to be 'fast, fluid and flexible', use forces of the 'social-era' such as social media, move towards a 'pull' strategy where customers demand the product before the firms produce them, and thus build upon these gaps between markets in the digital age, that ascertain a company's position in the market; these 'gazelles' out-maneuver the '800-pound gorillas' that dominate the 'jungle' and achieve competitive advantage, as was in the case of Netflix(the gazelle) that intervened and snatched the entire market from Blockbuster(the gorilla). Here the prospect of agility, is given more importance than market dominance, as omitted by Porter.

Although Dobbs, M.E., (2014), provides a model that a firm can utilise to develop strategic positioning, Porter himself does not provide a model to follow. Porter rather focuses on the five forces on their own, than how a firm can utilise these forces; and as Collis, D J., Rukstad, M G (2008) have stated, 'there is no point doing any work on strategy if workers aren't able to verbalise it and, as a result, act in line with it'. Grundy(2006) also thus explains why the Porter's five forces model, is infrequently(if at all) used by practising managers, as it abstract and analytical, it focuses on microeconomic theory rather than practicalities and also states that the model is highly prescriptive and somewhat rigid, whereby it does not give room for error or dynamism on its own.

Perhaps the most glaring flaw of them all, is that Porter's model is not a model that adheres to the sustainability of competitive advantage. It is a model rooted deep in the industry-based-view of modern-day strategic theory (and some would say even the source of), but like a lot of models of this view, the five forces model only enables a firm to attain competitive advantage, NOT maintain it.

This flaw, however, is overcome by other models of the Resource-Based-View that provide alternative frameworks. This view encompasses models such as Dynamic Capabilities by Teece et al. [2000] focusing on the agility of a firm's capabilities in the face of the modern dynamic world(for instance- Alphabet Inc.); The Core Competencies framework developed by Prahalad and Hamel[1996] that focused on developing core competencies that are intangible such as organisational culture or patents that sustain competitive advantage over a long time (for example in the case of Xerox - the Japanese firm that invented photocopying machines, and controlled the patent for over 10 years); and perhaps the most influential of all the RBV frameworks is the VRIN introduced by Barney[1991] , that proposed to achieve sustainable competitive advantage a firm must control a resource that is Valuable(V), Rare(R), Inimitable(I), and Non-substitutable(N), Barney[1991] also mentions the Barriers to Resource Imitability, Causal ambiguity, Unique Historical Trajectory and Time Compression Diseconomies, that can help attain and maintain sustainable competitive advantage.

Conclusion

In conclusion, if the forces are intense, as they are in such industries as airlines, textiles, and hotels, almost no company earns attractive returns on investment. If the forces are benign, as they are in industries such as software, soft drinks, and toiletries, many companies are profitable. Industry structure drives competition and profitability, and understanding it is also essential in effective strategic positioning (Porter, 2008)

Porter's value chain is antiquated in light of the social era. It was created at a time when being big and having scale was in itself a key aspect to competitive advantage and profitability (Merchant, 2012)

This is thus a testament to the school of thought that promotes the Five Forces as an incredible model, however one that is still deeply rooted in the past, and one that cannot be utilised in a dynamic and agile environment. A shortcoming that is pivotal in the modelling of modern-day strategy.

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