

Analyzing the Attractiveness of an Industry

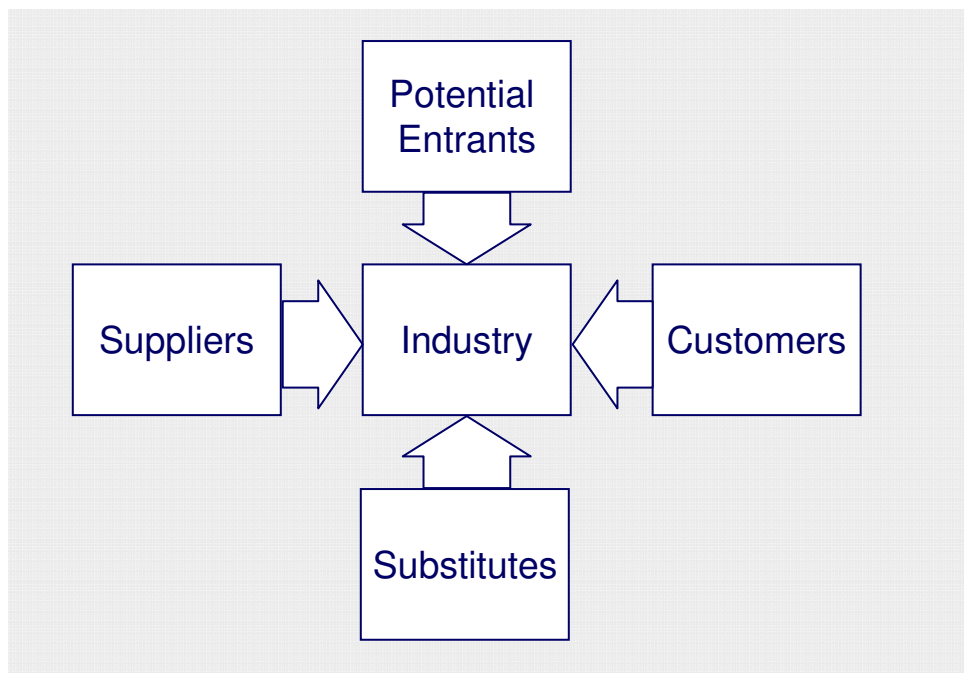
Using Porter's Five Forces Framework

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Porter's Five Forces framework is a simple yet powerful framework that identifies the strength of each of five market levers on an industry: Suppliers, Customers, Potential New Entrants, Substitutes, and existing rivals in the Industry. Knowing the strength of each force allows businesses to make wise decisions that minimize risk and maximize return in any industry.

Diagram of Porter's Five Forces



Suppliers

Suppliers are those who provide resources to the business. It might be suppliers of raw materials or products for resale, the landlord, or employees who provide the human resources for a business to run. Businesses determine the “force” that suppliers have by compiling all the variables of the supplier market and rank each for impact on the business.

For example, a businessman is thinking of opening a restaurant. He will look at suppliers of food noting their reliability, quality, pricing and whether they offer credit terms. Next he will find out if there are multiple potential suppliers or a single supplier. Multiple suppliers compete for business and typically offer better service, whereas a single supplier can hold a business hostage.

Next he will look at real estate resources, including potential landlords. Establishing a business at one location is an investment because there will be significant “switching costs” to move. It will be important for the businessman to note whether multiple businesses have left this location and the reasons.

Finally, the businessman will review the labor market in the area. What skills are necessary for this business? Are there enough skilled workers? What are the typical wages offered for similar jobs?

Once the businessman has compiled all these variables, he must determine the “force” that each variable will have on his business. That means he must determine whether the resources are available and strong enough for sustained business success.

Customers

Customers are simply potential buyers, and using Porter’s Five Forces framework businesses can determine how much control they will exert on the industry. For example, customers in the luxury market may be fewer in number and more demanding but more willing to pay higher prices, whereas customers of a more common market may comprise a larger market, be less demanding but more thrifty.

Are customers fickle or steady? Will they pay on credit or at the time of delivery? How strong are they financially? Once they make a purchase decision, how likely are they to do business with others? What are other key characteristics of customers and potential customers? And how important is each characteristic to the success of the industry?

Knowing the answer to these questions help a business determine not only whether a market is profitable, but provides additional useful information for pricing, marketing, and product offerings.

Potential Entrants

Just like the California Gold Rush, as soon as an industry is seen as profitable the competitors will fly in, destroying profits. But there are ways to counter this.

It is important to understand the barriers to entry: that is what keeps or will keep other competitors from entering the industry. For example, is significant capital required to purchase machines and buildings? Is proprietary knowledge or products required? Will entrants be at a disadvantage because they have no brand identity? Can customers switch easily to new entrants?

Once the barriers are identified, a business must determine the strength of each barrier against potential entrants. Doing so makes it easy to develop tactics, such as branding, to leverage barriers against others.

Substitutes

Substitutes are similar to competitors in that they may compete for customers.

For example, frozen pizza is a substitute for pizza delivery. In fact, the entrance of premium frozen and refrigerated pizzas such as DiGiornos had a significant impact on Pizza Hut and Dominos, working to shrink the market and drive down prices.

When it comes to analyzing the force of substitutes, businesses must understand the difference in price between their product and the substitute product as well as the susceptibility for customers to use substitutes. Whereas people will readily substitute a frozen pizza for a delivered one, they are less ready to substitute the bus for a used car, or substitute industrial parts due to the reengineering that might be involved.

Again, identifying the substitutes is only half of the information a business needs to analyze. The impact of each variable on the industry is also important to understand.

Industry

Finally, a businessman must understand the industry itself and the strength of the variables that comprise it. How many competitors exist? Is it a growing industry? Is there legislation in effect or pending regarding the industry? Do competitors have strong brands? Are there any barriers to a weak competitor closing its doors?

Use this section to do a thorough analysis of your competitors. Using the example of the businessman considering a restaurant as an example, some potential variables of the market might include, how many restaurants are there in the area? Are they chain restaurants or locals? What is their quality? What is their price? Where are they

located? Who is their target market? How many “like” restaurants are there in the area? How strong is their business?

The businessman would then determine which of those variables are most important to him and the strength of the competition in each variable category to get an accurate representation of the market.

Compiling the “Forces” to Understand the Industry

Identifying all the variables of each force and their strength in the industry might be a daunting task, but no other business analysis gives as robust a representation of the attractiveness of an industry as a whole. This analysis is useful for determining whether to enter an industry or specific market. It is also useful for identifying strengths and weaknesses, risks and opportunities.

For more information

To learn more about other components of strategic management, visit www.McKinneyStrategicManagement.com.

The McKinney Group, LLC was founded by Robert A. McKinney, a business strategist and classical entrepreneur, to focus on Maximizing Value Creation through Good Business Run Wisely. With his keen eye for excellence, proven business results and belief in the free market, Robert created The McKinney Group, LLC out of passion for entrepreneurship.

All functions of The McKinney Group, LLC are focused on businesses from startup to \$50MM, because this is where the great businesses of tomorrow are found. It's also where businesses are run on a tight budgets and lean resources. We specialize in helping these businesses through analysis, planning, strategizing and finding solutions that develop competitive advantage.

We know it's not just about the money. It's about your money.

We work with businesses we believe in. And we get results. Contact The McKinney Group, LLC and tell us your story.

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