The struggle between U.S. service stations and their suppliers—big oil companies—is another interesting example. When the popularity of E85 ethanol—a mixture containing 85 percent ethanol and 15 percent gasoline—began to rise in the mid to late 2000s, many U.S. service stations were prohibited from carrying the alternative fuel. Oil companies that do not supply E85 lose sales every time a driver fills the tank with the ethanol mix. As a result, many prohibit their franchisees from carrying fuel from other producers. Service stations that are allowed to carry E85 are often required to dispense it from a pump on a separate island not under the main canopy—a costly endeavor. Because there are only a few major oil companies and thousands of service stations in the United States, the oil companies are able to wield most of the power.[23]

The conditions that make suppliers powerful are similar to those that affect buyers. Specifically, suppliers are powerful under the following circumstances.

1. The supplying industry is dominated by one or a few companies. Concentrated suppliers typically exert considerable control over prices, quality, and selling terms when selling to fragmented buyers.
2. There are no substitute products, weakening buyers in relation to their suppliers.
3. The buying industry is not a major customer of the suppliers. If a particular industry does not represent a significant percentage of the suppliers' sales, then the suppliers control the balance of power. If competitors in the industry comprise an important customer, however, suppliers tend to understand the interrelationships and are likely to consider the long-term viability of their counterparts—not just price—when making strategic decisions.
4. The suppliers pose a credible threat of forward integration by "becoming their own customers." If suppliers have the ability and resources to operate their own manufacturing facilities, distribution channels, or retail outlets, then they will possess considerable control over buyers.
5. The suppliers' products are differentiated or have built-in switching costs, thereby reducing the buyers' ability to play one supplier against another.

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3-8 Limitations of Porter's Five Forces Model

Generally speaking, the five forces model is based on the assumptions of the industrial organization (IO) perspective on strategy, as opposed to the resource-based perspective. Although the model serves as a useful analytical tool, it has several key limitations. First, it assumes the existence of a clear, recognizable industry. As complexity associated with industry definition increases, the ability to draw coherent conclusions from the model diminishes. Likewise, the model addresses only the behavior of firms in an industry and does not account for the role of partnerships, a growing phenomenon in many industries. When firms work together, either overtly or covertly, they create complex relationships that are not easily incorporated into industry models.

Second, the model does not consider that some firms, most notably large ones, can often take steps to modify the industry structure, thereby increasing their prospects for profits. For example, large airlines have been known to lobby for hefty safety restrictions to create an entry barrier to potential upstarts. Mega-retailer Wal-Mart even employs its own team of lobbyists on Capitol Hill.

Third, the model assumes that industry factors, not firm resources, comprise the primary determinants of firm profit. This issue continues to be widely debated among both scholars and executives.[24] This limitation reflects the ongoing debate between IO theorists who emphasize Porter's model and resource-based theorists who emphasize firm-specific characteristics. The resource-based perspective is addressed later in the strategic management process.

Finally, a firm that competes in many countries typically must analyze and be concerned with multiple industry structures. The nature of industry competition in the international arena differs among nations, and may present challenges that are not present in a firm's host country.[25] One's definition of McDonald's industry may be limited to fast-food outlets in the United States, but may also include a host of sit-down restaurants when other countries are considered. Different industry definitions for a firm across borders can make the task of assessing industry structure quite complex.

These challenges notwithstanding, a thorough analysis of the industry via the five forces model is a critical first step in developing an understanding of competitive behavior within an industry.[26] In a general sense, Porter's five forces model provides insight into profit-seeking opportunities, as well as potential challenges, within an industry (see Case Analysis 3-2).

Case Analysis 3-2

Step 3: Potential Profitability of the Industry

Porter's five forces model should be applied to the industry environment, as identified in step 2, by examining threat of entry, rivalry among existing competitors, pressure from substitute products, and the bargaining power of buyers and suppliers. Each of the specific factors identified in the rivalry and new entrants sections (3-3 and 3-4) should be assessed individually. In addition, each of the five forces should be evaluated with regard to its positive, negative, or neutral effect on potential profitability in the industry. It is also useful to provide an overall assessment (considering the composite effect of all five forces) of potential profitability that identifies the industry as either profitable, unprofitable, or somewhere in between.

Step 4: Who Has Succeeded and Failed in the Industry, and Why? What Are the Critical Success Factors?

Every industry has recent winners and losers. To understand the **critical success factors (CSFs)**–factors that tend to be essential for success for most or all competitors within a given industry–one must identify the companies that are doing well and those that are doing poorly, and determine whether their performance levels appear to be associated with similar factors. For example, McDonald's, Burger King, and Taco Bell are successful players in the fast-food industry. In contrast, Rax and Hardee's have been noted for their subpar performance. Are any common factors partially responsible for the differences in performance? Consider that many analysts have noted that consistency and speed of service are critical success factors in the fast-food industry. Indeed, McDonald's, Burger King, and Taco Bell are all noted for their fast, consistent service, whereas Rax and Hardee's have struggled in this area.

A business may succeed even if it does not possess a key industry CSF; however, the *likelihood* of success is diminished greatly. Hence, strategies that do not shore up weaknesses in CSF areas should be considered carefully before being implemented.

Critical Success Factors (CSFs)
Factors that are generally prerequisites for success among most or all competitors in a given industry.

3-9 Summary

An industry is a group of companies that produce similar products or services. Michael Porter has identified five basic competitive industry forces that can ultimately influence profitability at the firm level: intensity of rivalry among incumbent firms in the industry, the threat of new entrants in the industry, the threat of substitute products or services, bargaining power of buyers of the industry's outputs, and bargaining power of suppliers to the indusuy. Firms tend to operate quite profitably in industries with high entry barriers, low intensity of competition among member firms, no substitute products, weak buyers, and weak suppliers. These relationships are tendencies, however, and do not mean that all firms will perform in a similar manner because of industry factors. Although Porter's model has its shortcomings, it represents an excellent starting point for positioning a business among its competitors.

Key Terms

barriers to entry
critical success factors
exit barriers
industry
industry life cycle
market share
relative market share
substitute products
switching costs

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Review Questions and Exercises

1. Visit the Web sites of several major restaurant chains. Identify the industry(s) in which each one operates. Would you categorize them in the same industry or in different industries (fast food, family restaurants, etc.)? Why or why not?
2. Identify an industry that has low barriers to entry and one that has high barriers. Explain how the difference in entry barriers influences competitive behavior in the two industries.
3. Identify some businesses whose sales have been adversely affected by substitute products. Why has this occurred?
4. Identify an industry in which the suppliers have strong bargaining power and another industry in which the buyers have most of the bargaining power. How does this affect potential profitability in both industries?

Practice Quiz

True or False

1. Each firm operates in a single, distinct industry.
2. All industries follow the stages of the industry life cycle model.
3. The likelihood that new firms will enter an industry is contingent on the extent to which barriers to entry have been erected.
4. Higher capital requirements for entering an industry ultimately raise average profitability within that industry.
5. Substitute products are produced by competitors in the same industry.
6. A key limitation of Porter's five forces model is its reliance on resource-based theory.

Multiple Choice

7. Industry growth is no longer rapid enough to support a large number of competitors in which stage of industry growth?
   - **A.** growth
   - **B.** shakeout
   - **C.** maturity
   - **D.** decline