Show Me the Money: Analyzing Porter's Five Forces

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Imagine you had $1,000 to invest any way you wanted to. What part of the economy would you investigate to find a good bet? Would you go with the airline industry and gamble on the popularity of air travel? Would you choose the cell phone market because, hey, everyone's gotta have one? Would you go with snack food? Sneakers?

How would you choose the best industry in which to invest your money?

How the Money Is Made

Economist Michael Porter has already asked that question – and come up with an answer. In 1980, he wrote a book, *Competitive Strategy*, in which he came up with five economic forces to explain why certain industries persistently outperform others. Those five forces are: rivalry; the threat of substitutes; buyer power; the threat of new entrants; and supplier power. These five forces have been successful for 30 years at evaluating why some industries consistently do better than others, says Joe Mahoney, professor of strategic management at the University of Illinois.

"It's a fundamental way to analyze an industry," Mahoney says of Porter's five forces. "Warren Buffett is a very old-school investor and always says he will not invest in any business unless he understands how it makes its money. Porter's five forces model is one tool to understand how the money is being made."

Assume you were thinking of buying stock in an online deal or coupon site, like Groupon, which recently went public and started trading its shares on the stock market. Using the Porter's Five Forces model, you might hold off before plunking your money down in the industry. Here's how it works:

Rivalry: Groupon is by far the leader in this new online discount industry, but it has many competitors, including LivingSocial, Google Offers and nearly 400 others, according to CNBC. Its closest rival, LivingSocial, is backed by giant online retailer Amazon.com, and is growing rapidly.

Threat of substitutes: For the most part, online deal sites haven't yet developed brand loyalty. People will find the best deal for the product they want, and probably won't care if it's on Groupon, LivingSocial, Google or another site.

What's more, other websites like DealGator and Deal Radar exist just to scan the Internet and gather all the deals in one place, giving Groupon and its competitors an even bigger challenge.

Buyer power: When it comes to Groupon, this is a bit of a mixed bag. Since it is easy to hop from one deal site to another, buyers can choose to switch fairly easily if they have a bad experience or find a better deal. But Internet deals usually require the shopper to pay in advance, with that money being split between the deal company and the business that's offering the deal. If the customer never redeems his deal voucher, then the two companies already have been paid and don't lose any revenue.

Barriers to entry: There are not many. It takes some computing power, a sales team and funding to get a daily deal site set up, and all three can be accomplished fairly cheaply. Newspapers across the country, for example, are launching their own deal sites to compete with the likes of Groupon and LivingSocial, which are seen as threats to the newspapers' advertising business. Even smaller players can get started without having to buy much equipment or even rent office space.

Supplier power: Businesses looking to push their deals through a Groupon-like site have some limitations, mostly because they may not be able to judge if the deal will benefit them or not. Many companies have complained that they ended up losing money by offering a daily deal, and they often can't negotiate better terms from the deal company to offset their losses. If the business offering the Groupon deal doesn't structure it correctly — by putting a limit on how many vouchers will be sold, for example, or offering such a deep discount that it loses money — the deal can be a bad business decision. But again, since there are so many companies in this industry, the firm that wants to offer a deal can do a lot of shopping around to find the best fit.

Don't Forget Cooperation

So does the online deal industry pass muster for a potential investor? That's up to the investor, Mahoney says, but Groupon's stock price offers a clue. Since it went public November 4 at $20 a share, the stock has gone up as high as $31.14 before sinking down to $18.77 just three weeks after its initial public offering.

Ultimately, Porter's five forces analysis can't answer all the questions you might have about making an investment, Mahoney adds. The model only works at an industry level, so even if you decide to invest in a daily deal site, you will have to do more research to find the right company. And the model focuses entirely on competition and ignores another force, which some consider to be the sixth part of the Five Forces model: cooperation.

"For some companies, there are complementary companies to consider," Mahoney says. "How valuable a computer company's hardware is depends on the amount and quality of the software available. Joint ventures, alliances, networks — all kinds of companies are working together in various ways to create more areas of cooperation, and that affects the industry's investment chances."

Want to comment on this story? Answer one or more of these questions to start the conversation:

Why is Porter's Five Forces model considered an important tool in evaluating an industry? What are its limitations?

Would you invest in Groupon or another online coupon site? Why or why not?

How might corporate "cooperation" affect an industry's financial well-being?

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