Application of Porter’s Five Forces Model Paper

Example 1: Fast Casual Industry

The Porter’s Five Forces Model illustrates how the competitive landscape in an industry is impacted by five prominent forces. These forces are: Supplier power, Threat of new entrants, Buying power, Threat of substitutes, and Rivalry. The degree of rivalry is the center of this model as the other 4 forces branch off of this. Each of the forces influences the nature of competition in the industry. Additionally, organizational strategies are often impacted as companies formulate their strategies in order to respond to the dominant competitive forces in any particular industry.
The bargaining power of suppliers is a reversal of the power of buyers. This force can also be described as the market of inputs. The suppliers of raw materials, labor, and expertise services provide industries and have power over industries (Quick MBA, 2010). The bargaining power is in the price for the materials or services provided. Many industries have a plethora of suppliers that offer these things needed, but some don’t. Some industries only have one or two suppliers and those suppliers can put any price on the materials/services they offer.

This is one of the bigger forces within the fast casual industry. Although the supplier power is usually weak, it still has a major impact on the industry. Most restaurants within the industry get their food from various butchers, farmers, and packaging companies; they don’t make their own. For example, most restaurants offer meat. There are many suppliers throughout the United States (7 located in Columbus). There are many options for restaurants to choose from and this will determine the price at which they will sell their products. As a result, this force is typically weak in this industry unless, like Chipotle, a unique and challenging supply chain is established. Chipotle’s focus on organic produce and free-range and antibiotic-free meats increases supplier power as the suppliers can demand higher prices for their products and thus, increase food costs to Chipotle (Kosas, 1998).

Within the fast casual food segment, the bargaining power of customers certainly plays an important role. When buyer power is strong, the buyer can essentially set the price (Quick MBA, 2010). The customers of the fast casual markets demand high quality food and a unique experience, coupled with a reasonable price. Although fast casual restaurants may raise prices, the industry must do so in ways that do not significantly exceed that of competitor’s or violate customer expectations (Lauron, 2009). This is because the restaurants must maintain a price that is lower than the casual experience of other restaurants. If the price of fast casual food becomes
too great, customers would unquestionably leave this market and venture to other restaurant segments. Because fast casual restaurants have been able to maintain a reasonable price to offer its product to customers, the restaurant segment was able to maintain reasonable growth even during the economic downturn of 2008-2009. For example, revenues increased and net income nearly doubled from 2008-2009 at Chipotle Mexican Grill (Chipotle 10-k, 2011).

The threat of new entrants is extremely high in the fast casual segment. The reason existing fast casual chains must understand that there is a threat of new entrants is because there are very few barriers to entry. It is relatively inexpensive to start up a restaurant. In a recent survey, average start-up costs for a restaurant was $225,000 (restaurantowner.com, 2011). This is relatively inexpensive for starting up a new business, making it rather easy for individuals to acquire the funds to start their own restaurant. Another important subject worth noting is the fact that it is the experience that sets fast casual restaurants apart from its competition, not solely the food. Thus, if someone can revolutionize the experience, it would be extremely easy to enter into the fast casual segment. This is perhaps the biggest reason fast casual restaurants must take note of any potential competition that could threaten their business.

Competition among firms is high in this industry. It comes down to gaining a competitive advantage over the other companies in an industry. Firms can obtain a competitive advantage by one or more of the following four ways: Changing prices, improving product differentiation, creatively using channels of distribution and exploiting relationships with suppliers (Quick MBA, 2010). The rivalry in an industry will be increased with a large number of firms because they are competing for the same customers and the relatively the same market share; people who eat food. There are dozens of fast casual restaurant chains that compete, as well as fast food restaurants that are trying to look like fast casual, and there are fast casual restaurants that have
not been franchised. All of these restaurants are competing for market share. Slow market growth also causes companies to compete for market share (Quick MBA, 2010). However, a firm can increase their revenues simply because of the expanding market. The market for fast casual restaurants as mentioned before is people who eat food. The market can grow based on people getting to the age where they eat the food provided by the restaurants. The market can also decline with deaths of past customers; generally these factors will balance themselves out.

Another characteristic pertains to fixed costs resulting in economies of scale and how those economies increases rivalry (Quick MBA, 2010). Fast casual restaurants do not have many high fixed costs. Rent is the same every month, and some restaurants might order some products the same amount every month, but most products are ordered in quantity of how the manager predicts they will sell. This along with utilities, wages, and ingredients can vary each month. The most successful companies will be the ones the not only sell a lot of food, but waste little of their inventory. The fourth characteristic described relates directly to the restaurant business in the sense that high storage costs or highly perishable products cause a producer to sell goods as quick as possible. As mentioned earlier, a restaurant can be successful if they do not have to waste the food that they order. If they order too much, they are left throwing a lot of food away or selling it at a very cheap price. If they order too little, they could run out and not be able to provide the customer with the dish they want. Low switching costs is something that creates immense rivalry within the fast casual restaurant industry (Quick MBA, 2010). Because of the quantity of fast casual restaurants, a consumer is almost always very close to a dining establishment. This leads to much competition not only between quick service restaurants, but also casual and fine dining. Product differentiation is the sixth characteristic of rivalry. The fast casual industry has high product differentiation which is good for the consumer because they
have options between Mexican, Chinese, Italian, American, and Indian. This is good for the firms because most of the, only offer one style of food. This high product differentiation lowers rivalry because there are usually four or five restaurants all located next to each other, but they offer different styles. So consumers will be able to pick the cuisine they are in the mood for and can also go next door to another restaurant if the wait is too long at the place they were originally going to.

The seventh characteristic that influences the intensity of rivalry deals with strategic decisions (Quick MBA, 2010). When a firm is losing market share, they might try something out of the box in order to get more attention. We typically do not see this with fast casual restaurants. They tend to offer the same food for the same prices throughout the year. A fast food restaurant is where we see extreme promotions and new creations. It is often a really big burger, a pile of tacos, or subs for very cheap prices. The next characteristic the makes firms compete is the imminent high cost of giving up on a product (Quick MBA, 2010). This pertains to a restaurant closing. In most cases, it is not worth it to close in rough times because the plant and equipment is not worth much. Instead, companies continue to compete and take as much market share as they can until they get a new strategy. A diversity of rivals as mentioned is a positive thing because people do not want to eat the same thing everyday, so having multiple restaurants with different flavors and foods offered will satisfy the customer and allow for each restaurant to compete for market share even if the share the street with 5 other restaurants. The final characteristic is industry shakeout. This relates to the fast casual restaurant business because of the fact that fast casual restaurants are cheaper to open then fast food or casual restaurants and on average have better profits (Healthy Restaurant Concepts, 2011). This can attract new firms to enter the market and existing firms to expand. Eventually the market will become so diluted that
it will creating intense competition because in the end, the weak companies will be forced out (Quick MBA, 2010).

The threat of substitutes refers to products outside of the industry. A threat of substitutes exists when a product’s demand is affected by a price change in a substitute product. In the Porter model, the threat of substitutes usually impacts an industry through price competition (Quick MBA, 2010). Fast casual restaurants, by nature, do not have to compete with other fast casual restaurants when it comes to price. The average checks per person range from $7-$11, if the restaurant stays within that range, then they will not lose customers because the other fast casual restaurants’ price’s fall within the same range (Healthy Restaurant Concepts, 2011). The threat of substitutes comes into play when people decide to go to a casual or a fast food restaurant or eat at home. As a result of a large number of options, this force is relatively high. The fast food restaurant can compete with fast casual because they can offer cheaper prices. In tough economic times, consumers might shy away from fast casual restaurants and turn to purely eating at home or fast food restaurants. Fast casual restaurants still maintain the advantage because they offer better food preparation and quality, as well as a more casual dining lounge. Casual restaurants only stand as a threat if the consumer wants to sit down and be waited on, and if they want to pay more. Companies can reduce the threat of substitutes by staying in tune with the preferences of their customers. If the company is able to offer different products that adhere to what the customers want, they will be able to maintain a competitive advantage over rival firms and be able to keep their customers rather than lose them to substitute restaurants (Fulton, Akridge, & Ehmke).

Understanding these five forces is crucial for the success of any business. In the fast casual segment of the restaurant industry all five forces are relatively strong, except for
bargaining power of suppliers, which, in certain circumstances, can be strong as well (e.g. Chipotle’s Food with Integrity). As a result, this is an extremely competitive industry that is fairly mature. Margins are thin, competition is fierce, and consumer taste preferences evolve.