DUVAL & STACHENFELD LLP

The Real Estate Philosopher
Porter's Five Forces in the Real Estate World

Michael Porter is a professor at Harvard Business School. He has spent his long career analyzing strategy and competition. His analysis is exceptional and probably just about everyone in the business world knows all about him; however, I have never seen his theories applied to the real estate world.

The most interesting thing about Porter's work, at least to me, was his admonition that the goal should "not" be to "compete" with one's competitors, as all this really does is give away your upside to your customers, employees, suppliers and other parties (e.g., competing on price just helps the customer). Instead, the smartest thing is to do something "different" from your competitors. Indeed, asked what the biggest mistake companies (and those leading them) make, Porter's response is exactly that: Companies trying to beat their competition when the goal should instead be to extract as much "value" as they can out of their industry.

Porter, after many years of thought and analysis, concluded that there are five forces that dictate the competitive situation in an industry. In a nutshell, and generally speaking, when these forces are strong, it is kind of rough to be a player in the industry, and when these forces are weak, it is great times.

As the managing partner of a New York real estate law firm, I have performed this analysis for my firm and have found it to be quite helpful. Indeed, the sine qua non of my law firm is to try to be different from other law firms by becoming a top player in the real estate niche, rather than trying to be all things to all people. Instead, my firm focuses "only" on real estate; hence, our brand as The Pure Play in Real Estate Law.

I am now going to do my best to illustrate how one might do this for an "industry" that is part of the real estate world.

Also, I would like to emphasize that this is not pointless philosophizing, as I would think that anyone considering entering an area within the real estate industry, or considering a project in an area of the real estate industry, should logically do exactly this analysis.

Before one can get to an analysis of the five forces within an "industry", one has to define what "industry" it is that one is analyzing, and that is not as easy as it might seem. I mean, is the industry to be analyzed:

All real estate in the world?

Of course not. Is it then:

All real estate in, say, New York City?

Still kind of too broad, so maybe:

Building housing in New York City?

I think still too broad, so how about

Building condominiums in New York City?

Even that may be too broad as most people think there are three sub-markets consisting of relatively affordable, medium range, and super high-end luxury, so how about:

Building super high-end luxury condominiums in New York City?

That sounds kind of reasonable to me as an industry for analysis, so let's go with that for purposes of this article; however, as I hope is relatively obvious, an "industry" could consist of innumerable concepts including those based on geography, product type, way of doing business (locally, nationally or internationally), deal structure, new economy, etc. There are always innumerable ways to define the industry one is analyzing and it is easy to get bollixed up and diverted or to fool yourself in this analysis; however, for the conclusions to have any use this is critical to do. I deliberately picked a relatively easy industry concept for purposes of this article.

So now let us embark on our analysis of the Five Forces as applied to the industry that is the building and selling of super high-end luxury condominiums in New York City.

If you have been wondering, here are the Five Forces, which I will go through one by one to reach a conclusion as to whether the competitive forces are low, medium or high:

Competitive Rivalry

Threat of New Entrants

Threat of Substitutes

Bargaining Power of Buyers

Bargaining Power of Suppliers

Competitive Rivalry: This one seems to be quite **high**. There is a ton of competitive rivalry right now. There are quite a few players building and selling super high-end luxury condominiums in New York City.

Threat of New Entrants: This one seems to be relatively **low** or at best **medium**. It is not so easy for someone to just go out and build a super high-end luxury condominium in New York City. There are innumerable regulations and other obligations to be dealt with. Plus the reputation of the party building the condominiums has a great deal to do with a project's success, which is a further barrier to a new entrant. Accordingly, a new player will have a great deal of trouble just moving into this industry.

Threat of Substitutes: This one seems to be quite **low**. It is difficult to come up with a substitute to this product as there is only one New York City. One could argue that living in Brooklyn is a "substitute", and there is a slight element of that; however, overall I would say this threat is a low one in view of how we have defined the industry. Another possible "substitute" could be renting instead of buying; however, that also doesn't seem quite applicable at the top end of the luxury market.

Bargaining Power of Buyers: Of course this fluctuates, but right now the bargaining power of buyers seems pretty **high** as there seems to be more super high-end luxury condominiums than buyers. The obvious difficulty in analyzing an industry such as building and selling super high-end luxury condominiums, that makes the risk/reward perspective so much worse, is that you are not selling your product right now but in the future when you don't know what the bargaining power of buyers will be. To be safe, even in a time of a shortage of luxury high-end apartments, you would have to assume the bargaining power of buyers is high even at times when it isn't.

Bargaining Power of Suppliers: This one seems to be very **high** as well since one of the problems in making a profit in this market is it is taking longer to obtain the necessary supplies, plus the pricing has risen for these supplies. Indeed, workers, to my mind, are also technically suppliers too; and, due to the construction boom, the cost of workers is much higher.

So to sum up:

Competitive Rivalry:	**High**
Threat of New Entrants:	**Low/Medium**
Threat of Substitutes:	**Low**
Bargaining Power of Buyers:	**High**
Bargaining Power of Suppliers:	**High**

Looking at the above it seems that overall the Five Forces are pretty strong in the super high-end luxury condominium industry in New York City. This would mean that it is (probably?) not the best industry to go into right now because it will be more difficult to make a profit.

. . . . .

So this is a very quick and dirty analysis of how one might apply Porter's Five Forces to the real estate world. I did it very fast here and without a ton of depth as my goal was to illustrate rather than dive into a deep analysis.

To sum up, and hopefully make this article useful to you in your real estate business, the way to apply Porter's Five Forces is as follows:

First – figure out what "industry" you are in or are you would like to move into. This should not be quick and dirty. You really want to spend a lot of time on this as there are many subtleties and you can end up with the right or wrong results just by how you define the industry. It is actually the most difficult part of the analysis. For example, is Ford Motor Company in the "car business" or is it in the business of "transporting people." And are you in the business of building buildings for people in a certain market or in the business of providing a lifestyle for people. You could see a lot of difference in analysis and results depending on this.

Second – go through the five forces and analyze each one as it applies to your industry.

Third – be honest with yourself about the application of these Five Forces to your plans and take these Five Forces into account in planning your actions. Of course, this is not the whole story, and a possible problem for Porter's analysis is likely the cyclical nature of the real estate markets that you have to adjust for (i.e. the Five Forces may change a great deal from the day you start a project until the day it is ready to be sold). However, overall the goal with the Five Forces is to permit you to make a more informed decision whether to go into a market deeper or possibly to get out.

In my next article, I am going to work further with Professor Porter's works and apply his definition of competitive advantage to the real estate world. To get you excited about my next article, I will give you his definition, which I find incredibly insightful:

> **Competitive advantage depends on offering a unique value proposition delivered by a tailored value chain, involving trade-offs different from those of rivals, and where there is a fit among numerous activities that become mutually reinforcing.**

<u>Point of Interest from Duval & Stachenfeld LLP</u>:

We have started a **Developer Value Add Practice Group for New York City Development Projects**. This is an outgrowth of our general value proposition that, instead of "just" doing great legal work (like most law firms do), our core mission is to "help our clients grow their businesses". For real estate developers this includes:

- Special connections for developers to our extensive list of institutional and non-institutional clients and friends of the firm that invest in real estate. The players include opportunity funds, value-add funds, insurance companies, sovereign wealth funds, family offices, high net worth individuals, investment banks and other parties with an interest in real estate investment. All of these connections are made on a principal-to-principal basis and without any fee or compensation to us.

- Expertise in New York City development transactions. This includes – in addition to the necessary skills in buying, selling, developing and financing – in-depth expertise in land use, environmental, assemblages and complicated developments with many moving parts.

- In-depth experience in joint ventures (which is our sweetest sweet spot).

- Intensive knowledge of the real estate industry in New York City that gives rise to insights and strategic business advice.

- Finally, it bears mention that our thinking is dedicated not only to handling the legal issues. We also provide very useful business advice on how to improve the economics of transactions.

If you are a developer in New York City with a project (large or small) and our value proposition is of interest to you, I encourage you to call me at 212-692-5550 or email at bstachenfeld@dsllp.com.