

Profit Pools

Key Points:

- A profit pool represents the total profits earned in an industry along all points in the industry value chain.
- Understanding an industry's profit pool is critical to understanding where, how and how much money is being made throughout the industry.
- More effective strategic decisions can be made once the industry profit pool has been mapped and analyzed.

Main Thoughts:

The concept of an industry profit pool was developed by consultants Bain & Company in 1998. A profit pool represents the total profits earned in an industry along all points in the industry value chain. Profit pools provide another way to analyze industry-specific performance. Where the five forces analysis examines the drivers of industry return and strategic groups identify where firms are positioned in the industry, profit pools evaluate profits along all points in the industry value chain. By analyzing profit pools, firms are better equipped to make strategic decisions since they will know specifically where profit maximizing opportunities lie throughout the value chain. Mapping an industry's profit, while conceptually simple, can prove challenging in practice. Mapping the pool requires four steps.

Define the Pool's Boundaries. The first step in the mapping process entails identifying the detailed activities that comprise the industry value chain. Analysis first begins at the individual firm level (i.e. the mapping creator's specific value chain) and then expands to include suppliers, customers and competitors. The intent is to define or—in some cases redefine—the traditional boundaries of the industry for purposes of including different business models and non-traditional activities that might constitute future sources of profits. The ultimate definition of the boundaries should take into account the issues faced by the firm creating it.

Estimate the Pool's Overall Size. Next, the overall size of the industry profits needs to be estimated. Analyst reports offer a useful starting point; however, because the boundaries have been redrafted per the first step, these will likely be insufficient to develop a full picture. A build up of profits can be created by aggregating the performance of individual companies. Public company information can be easily captured, while private company data may have to be estimated from public data. Industry profits can also be developed using other approaches such as product build ups. No matter which path to profit estimation is used, the method employed must provide a reasonable estimate of industry-wide performance.

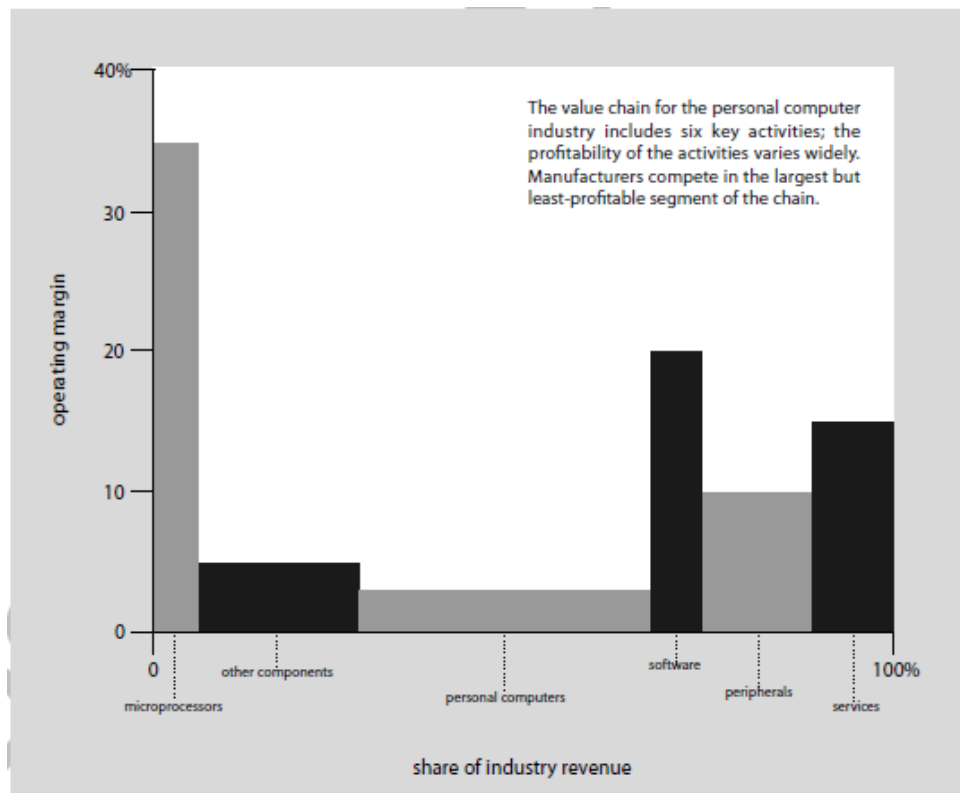
Estimate the Size of Each Value Chain Activity in the Pool. Per the concept creators, this step is the most challenging in the process. For each activity in the value chain, the profit for that activity needs to be estimated. The first step often comes from analyzing the performance of the firm doing the analysis to help understand baseline economics. Pure play companies in the industry are then examined, followed by mixed players (i.e. firms that participate in different links in the value chain). By focusing the analysis on the largest players, a preponderance of the analysis will have been created. The process is iterative and takes advantage of analyze and public company data available.

Check and Reconcile Calculations. The final step entails summing the profit estimates of the individual activities and comparing the total to the aggregate estimate of industry profitability. Significant variances between the amounts need to be reconciled. These variances likely stem from estimates made during the process of assessing the size of each value chain activity in the pool.

As an Example:

The following is an example of the profit pool for the microcomputer industry taken from the 1998 Harvard Business Review Article, *Profit Pools: A Fresh Look at Strategy*.

Figure 1: Profit pool for the personal computer industry (Gadiesh & Gilbert, 1998, Harvard Business Publishing)



Editorial

The Profit Pool concept is billed by its creators as ‘a fresh look at strategy’. This is a fair point mainly because, until the article’s release, many senior managers viewed strategy in terms of market share or sales share instead of profit share oriented. Certainly the idea of managing a firm to maximize profitability is not new; however, the idea of formulating strategy based upon the most promising profit opportunities is.

In both of the Harvard Business Review (HBR) articles from which this brief was drafted the authors explain in detail the purpose of profit pools as well as how to create a profit pool map. For anyone familiar with the concept of the value chain or activity-based costing, this type of analysis will not appear new. The trick, however, is creating the analysis which is presumably why the second article on profit pools—*How to Map Your Industry’s Profit Pool*—immediately follows the first in the same HBR edition. These types of analysis

are highly insightful, but they require time and thoughtful analysis to create. For those managers who are willing to make the effort, the payoff potential is high. For those not, the annual loop around the strategic planning track will likely yield the same findings as those that came before.

For More Information See:

Web

n/a

Magazines & Journals

Gadiesh, O., and Gilbert, J., *Profit Pools: A Fresh Look at Strategy*, Harvard Business Review, May-June 1998.

Gadiesh, O., and Gilbert, J., *How to Map Your Industry's Profit Pool*, Harvard Business Review, May-June 1998.

Books

Grant, R. *Contemporary Strategy Analysis*, Blackwell Publishing, 2005.