Profit Pools

Idea In Short

In today's hyper-competitive business environment, meeting customers' requests while making a profit is a herculean challenge. To be relevant & fulfill customers' ever-increasing demands, businesses must constantly grow & improve. However, for many businesses, profit is still a distant dream. There are several start-ups & businesses with significant investor funding are yet to break even. The profit pools perspective suggests that managers & businesses focus on profits, rather than on revenues. Organizations should evaluate their positioning in their industry's value chain to appraise the lucrativeness of their portfolio.

Orit Gadiesh, an Israeli consultant, & James L. Gilbert, an American consultant, both from Bain & Co., published the Profit Pools approach in the Harvard business Review article - Profit Pools: A Fresh Look at Strategy1. The approach advocates that managers & businesses should concentrate on profits rather than solely on revenues. According to Gadiesh & Gilbert, a profit pool is defined as the entire profits made in an industry at all points along the value chain:

> the total profits earned at all points along the value chain of an industry. Companies that see what others do not see, will be best prepared for capturing a larger share of the profits in an industry.

The notion of a profit pool is simple; however, the structure is frequently rather complicated. The authors' main point is that managers & businesses should look beyond revenues to determine their sector's or industry's profit pool2.

Objective

Profit pools can take several forms, depending on the economic & competitive forces at play in a particular sector or industry arena. Companies can leverage their pool knowledge in a

variety of ways, including identifying new profit opportunities throughout an industry's whole value chain. However, rather than simply raising sales, the ultimate goal is to improve the company's profits. Hence, it should analyze all the stages of the value chain to attain the said objective. The profit-pool provides a unique viewpoint on a sector, particularly for businesses that are accustomed to thinking in terms of revenues. Using the lens to develop strategy may necessitate challenging previous beliefs, revisiting old decisions, & pursuing counterintuitive initiatives. For example, a corporation may want to put off pursuing clear development prospects in favor of focusing on less attractive industry divisions with larger profit pools. It may eliminate established client groups, product lines, & even entire businesses to concentrate on the highest profit margins. It may purposefully diminish profits in one part of its business to increase profits in another. Even a company's perception of its competition might shift. It may, for example, opt to work with competitors to resist or exploit value-chain alterations that threaten a profit pool that already is in place.

Profit pool

A profit pool is defined as the total profits earned in an industry at all points along the industry's value chain. Profit pools can be divided into numerous categories, including business segments, rivals, products, regions, & stages of the value chain. A firm in any industry may operate in one or more segments along the value chain of that industry, & its profitability is determined by the profitability of the segment in which it operates. Profit pools can help a business stay ahead of the competition & maintain good margins.

Industry analysis

When analyzing any industry, keep in mind that:

1. **Segment definition:** No market, no matter how homogeneous or narrowly defined, has a perfectly even distribution of profit. Some sectors of the value chain will have a deeper pool than others. And, their depths will vary even within a single section. Profit concentrations result from the actions & interactions of companies & customers, & they form in areas where barriers to competition exist
2. **Profit sources:** In any business, there are multiple sources of profit. There are always products, customers, areas, or channels that produce above-average returns. Even in a sea of seemingly identical customers & products, companies who detect profit variability & can exploit the deepest pools will earn greater returns

3. **Growth isn't a panacea:** Increased revenue does not necessarily guarantee increased profits. As a result, growing market share isn't always the best solution to a company's problems
4. **Marketplace & industry dynamics:** Profit pools are not stagnant & can change quickly & dramatically. Upon changing market conditions & industry power structures, profit pools can shift from one segment to another. Companies that can predict this movement are better poised to harvest the resulting profits

Hence, understanding profit-pool dynamics can help companies make key decisions about every aspect of their operations & strategy, leading in many cases to the development of new, more profitable business models. Companies can also use their understanding of the profit pools to:

- find new sources of profit in low-margin industries
- guide product, pricing, & operating decisions
- chart acquisitions & expansion strategy
- choose which customer segments to target & which marketing channels to employ

Mapping / Creating a Profit Pool

The steps mentioned below can be used to create a profit pool for any industry.

1. List all the activities in the value chain in a sequential manner - Take a broad view of the value chain & look beyond the traditional industry definitions
2. Estimate total pool profit - Develop a baseline estimate of cumulative profits using at least two different views (say product-level & company-level)
3. Estimate profits for each value chain activity
4. Final estimates of activity & total pool profit - Reconcile the estimates by comparing outputs in steps 2 & 3
5. Plot all value chain activities (with the revenue generated) on X-axis & operating margin % on Y-axis. The area formed represents the size of the profit pool in each activity.

Now, this understanding about the profit pools can be used to make strategic decisions about the company.

Advantages

The Profit Pool technique is quite effective in increasing a company's profitability. With the use of this method, you may quickly access into revenue profits as well. The following disadvantages of lean management must be considered by the implementor. The Profit Pool technique is quite effective in increasing a company's profitability. With the use of this method, you may quickly access into revenue profits as well. Among the countless advantages of Profit Pool, the following are a few that can be easily reaped after implementation

- Right mapping of profit opportunities: Profit Pool Mapping assists in determining the location & amount of profit concentrations within an industry. Managers have the ability to investigate the appropriate regions
- Detailed analysis: It provides a thorough examination of the industry's structure & competitive dynamics. It provides precise analysis that management may use right away
- Simple to implement: It also highlights the industry's most crucial components that will lead to increased profitability in the future. The findings are simple to implement for managers

Disadvantages

There are various advantages to this method, but there are also some drawbacks. The following disadvantages must be considered by the implementor.

- **Good Infrastructure & Database is required:**Access to precise financial data points is necessary for mapping profit pools, which necessitates a good infrastructure & database. Accurate data may be difficult to get by for new businesses & start-ups
- **Time consuming Process:** It takes a long time. Process: It's a time-consuming calculation. Companies & managers must devote a significant amount of time to developing a plan
- **Complex & complicated:** Complicated & difficult: For an industry with a complex value chain, profit pool mapping can become more difficult. Conglomerates, for example, may face significant difficulties

Summary

The Profit Pool is a great strategy for managers & companies to improve the profitability of a company. This strategy concentrates heavily on profits & not only on revenues. Orit Gadiesh & James L. Gilbert came up with the Profit Pools strategy. Over time, this strategy has been employed by various industries from supply chain to electronics. This strategy is not limited to any industry as it explores all the different avenues available for a business to increase profits in its industrial value chain.