Successful companies understand that profit share is often more important than market share.

PROFIT POOLS: A FRESH LOOK AT STRATEGY

BY ORIT GADIESH AND JAMES L. GILBERT

THROUGHOUT THE EARLY 1990S, U-Haul, Ryder, Hertz-Penske, and Budget waged a fiercely competitive battle in the U.S. consumer-truck-rental business. U-Haul, long the dominant player in the industry, appeared to be at a disadvantage. With its older fleet of trucks, it had higher maintenance costs than its rivals, and it charged lower prices. Barely breaking even in truck rentals, it seemed fated to fall from industry leader to industry laggard.

PHOTO BY BRAD MAUSHART/GRAPHISTOCK

But the numbers on the bottom line told a different story. U-Haul was actually the most profitable company in the industry, its 10% operating margin running far above the industry average of less than 3%. Ultimately, in fact, the number two competitor, Ryder, abandoned the consumer rental business, selling off its fleet in 1996 to a consortium of investors.

What explains U-Haul's success? Answering that question requires us to step back and examine not only U-Haul's strategy but also its industry's profit structure. U-Haul prevailed because it saw something its competitors did not. By looking beyond the core truck-rental business, it was able to spot a large, untapped source of profit. That source was the accessories business, consisting of the sale of boxes and insurance and the rental of trailers and storage space – all the ancillary products and services consumers need to complete the job that has only begun when they rent a truck.

The margins in truck rentals are low because customers shop aggressively for the best daily rate. Accessories are another matter altogether. Once a customer signs a rental agreement for a truck, his propensity to do further comparison shopping ends. He becomes, in effect, a captive of the company from which he's renting the truck. Because there is virtually no competition in this piece of the value chain, the accessories business enjoys highly attractive margins.

Recognizing the true profit structure of its business, U-Haul seized first-mover advantages in accessories. For example, it scooped up the cheapest storage space in key locations before its competitors could react, gaining a sizable cost advantage. And, since control of the accessories business was tied directly to the volume of truck rentals, U-Haul deliberately kept its daily rental rates low in order to attract more and more customers to whom it could sell more and more high-margin accessories. Its competitors, in contrast, set their prices in a way that would maximize their returns from the core truck-rental business.

U-Haul's strategy redefined the consumer truck-rental business, giving the company control of a large share of its industry's profits. U-Haul recognized that while the core rental business represented the vast majority of the industry's revenue pool, accessories provided a large share of the industry's profit pool. By crafting a strategy to maximize its control of the profit pool, U-Haul was eventually able to dictate the terms of competition within the industry. Its rivals learned a valuable lesson the hard way: there are many different sources of profit in any business, and the company that sees what others do not – namely, the profit pools it might create or exploit – will be best prepared to capture a disproportionate share of industry profits.

__Orit Gadiesh__ is the chairman of Bain & Company in Boston, Massachusetts. __James L. Gilbert__ is a director of the firm.

The Profit-Pool Lens

A profit pool can be defined as the total profits earned in an industry at all points along the industry's value chain. Although the concept is simple, the structure of a profit pool is usually quite complex. The pool will be deeper in some segments of the value chain than in others, and depths will vary within an individual segment as well. Segment profitability may, for example, vary widely by customer group, product category, geographic market, or distribution channel. Moreover, the pattern of profit concentration in an industry is often very different from the pattern of revenue concentration.

As the U-Haul case illustrates, the shape of a profit pool reflects the competitive dynamics of a business. Profit concentrations result from the actions and interactions of companies and customers. They form in areas where barriers to competition exist or, as in the accessories business, in areas that

Gucci's Gulch: The Problem with Growth

For most managers today, growth is the holy grail. When charting strategy, they focus on ways to expand revenues, believing (or at least hoping) that higher sales will bring higher profits. The assumption is that a company able to capture a large proportion of revenues in an industry – a large market share – will reap scale efficiencies, brand awareness, or other advantages that will translate directly into greater profits. If you can grow faster than your competitors, the thinking goes, profits will surely follow.

There's one problem with this logic: it's wrong. Profits don't necessarily follow revenues. Consider the recent experience of Gucci, one of the world's top names in luxury leather goods. In the 1980s, Gucci sought to capitalize on its prestigious brand by launching an aggressive strategy of revenue growth. It added a set of lower-priced canvas goods to its product line. It pushed its goods heavily into department stores and duty-free channels. And it have simply been overlooked by competitors. And, of course, profits do not tend to stay in one place, waiting to be scooped up by the next opportunist. The profit pool is not stagnant. As power shifts among the players in an industry – the competitors themselves, their suppliers, and their customers – the structure of the profit pool will change, often quickly and dramatically.

Although many executives understand these truths intuitively, they often pursue strategies that run counter to them. They focus on revenue growth and market share and assume that profits will follow. (See the insert "Gucci's Gulch: The Problem with Growth.") In fast-paced businesses, that strategy is especially dangerous: today's deep revenue pool may become tomorrow's dry hole. To create strategies that result in *profitable* growth – every company's true aim – it helps to begin by creating a systematic picture of the industry's profit pool.

A profit-pool map answers the most basic questions about an industry: Where and how is money being made? The simple act of mapping can provide an entirely new perspective on even the most familiar industry. (See our article "How to Map Your Industry's Profit Pool" in this issue of HBR.)

Consider the U.S. automotive industry, which in 1996 generated revenues of about $1.1 trillion and profits of about $44 billion. The industry's revenues and profits are divided among many value-chain activities, including vehicle manufacturing, new and used car sales, gasoline retailing, insurance, after-sales service and parts, and lease financing. (See the chart "The U.S. Auto Industry's Profit Pool.") From a revenue standpoint, car manufacturers and dealers dominate the industry, accounting for almost 60% of sales. But the profit-pool lens reveals a different picture. Auto leasing is by far the most profitable activity in the value chain, and other financial products, such as insurance and auto loans, also earn above-average returns. The core activities of manufacturing and distribution, on the other hand, are characterized by weak profitability – they account for a significantly smaller share of the profit pool than they do of the revenue pool.

From the profit-pool perspective, then, the automotive business is as much about financial services as it is about the production and sale of vehicles. This fact hasn't been lost on the Big Three automakers, which have all moved aggressively into auto financing. Ford, in fact, has generated nearly half its profits from financing over the past ten years, even though financing has accounted for less than one-fifth of the company's revenues.

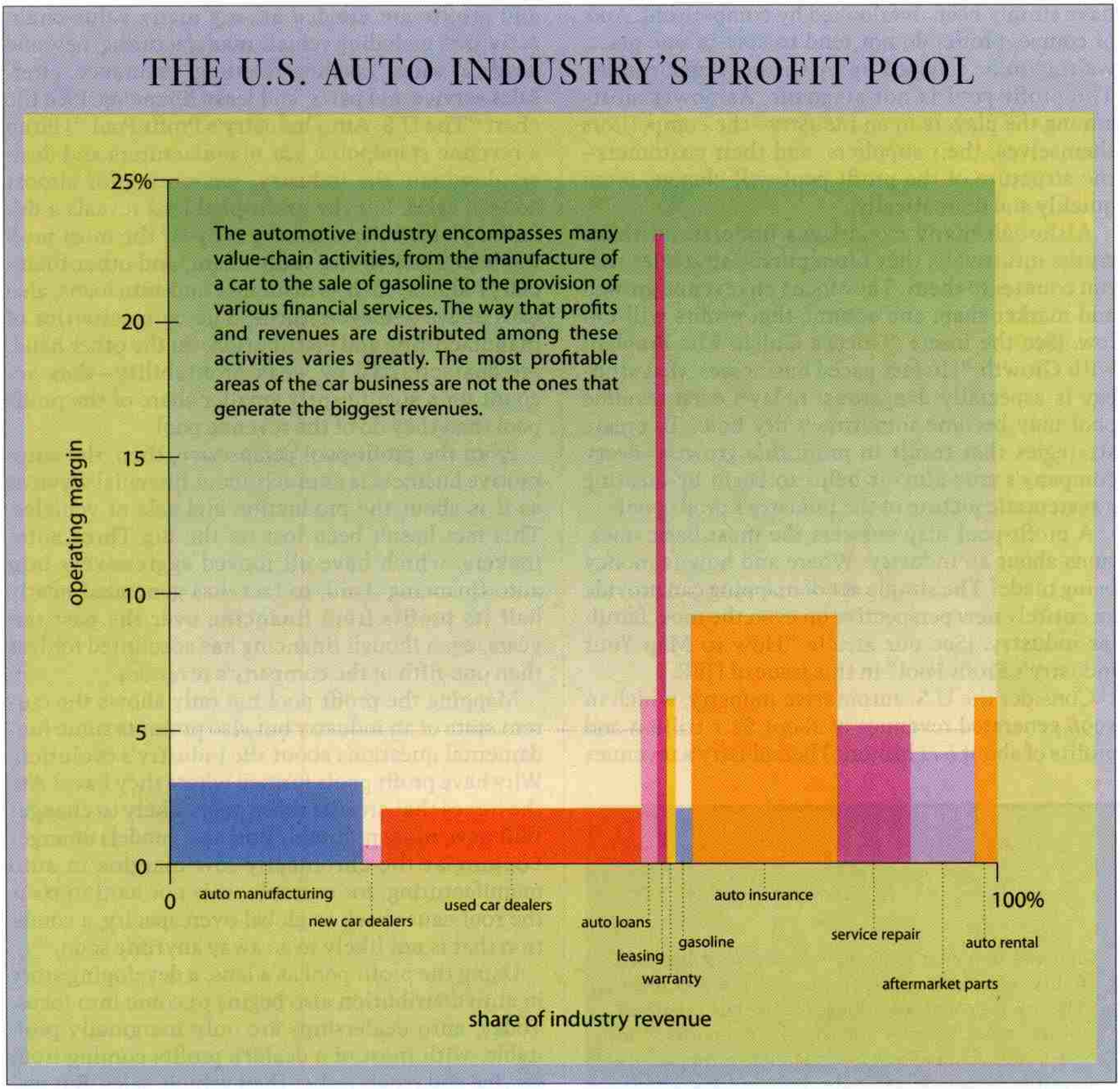
Mapping the profit pool not only shows the current state of an industry but also prompts some fundamental questions about the industry's evolution: Why have profit pools formed where they have? Are the forces that created those pools likely to change? Will new, more profitable business models emerge? Looking at the chronically low margins in auto manufacturing, for example, it is not hard to trace the root cause back to global overcapacity, a condition that is not likely to go away anytime soon.

Using the profit pool as a lens, a developing story in auto distribution also begins to come into focus. Today, auto dealerships are only marginally profitable, with most of a dealer's profits coming from service and repair rather than vehicle sales. But one relatively bright spot for car dealers in recent years has been used cars. In 1996, the margin on used car sales was triple that earned on new car sales. Not surprisingly, many dealers have been investing heavily in building up their used car business.

Is that strategy likely to succeed? The profit pool map prompts us to examine how some profit sources exert influence over others and shape competition. In this view, the high margins in leasing – which have led manufacturers to push for growth in that segment – can be seen as a real threat to used car profits. How? In coming years, waves of leased cars will flood used car lots, increasing supply and in turn eroding prices, margins, and dealer profits. Large car dealers that recognize this impending

allowed its name to appear on a host of licensed items such as watches, eyeglasses, and perfumes. The strategy worked – sales soared – but it carried a high price: Gucci's indiscriminate approach to expanding its products and channels tarnished its sterling brand. Sales of its high-end goods fell, leading to an erosion of profitability. Although the company was eventually able to retrench and recover, it lost a whole generation of image-conscious shoppers in some countries.

Gucci's misstep highlights the problem with growth: the strategies businesses use to expand their top line often have the unintended consequence of eroding their bottom line. Gucci attempted to extend its brand to gain sales – a common growth strategy – but ended up alienating its most profitable customer segments and attracting new segments that were less profitable. It was left with a larger set of customers but a much less attractive customer mix.



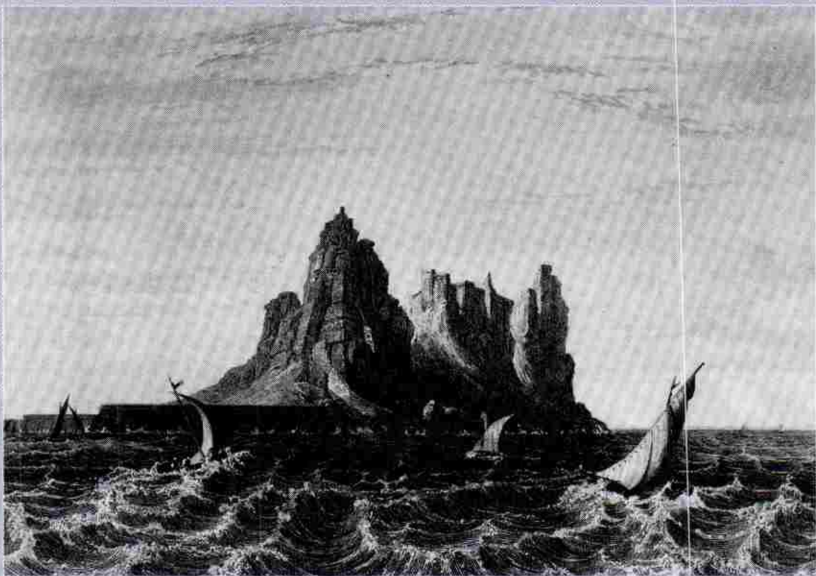
change are scaling back their investment in used car sales and exploring ways of entering the funding side of the financing business. After all, they already control the main points of customer contact and in many cases are already the conduit for loans and leasing packages. Dealers that fail to understand these profit-pool dynamics may well find themselves floundering in the shallows of the pool.

Turbulent Industries

The profit-pool lens can be particularly illuminating in industries undergoing rapid structural change. Such change, whether triggered by deregulation or new technology or new competitors, always results in a shift in the distribution of profits along the value chain. While rapid change can open new sources of profit, it can also close off traditional sources. For industry leaders, the shift can be very dangerous, threatening their control over the profit pool. (See the insert "Choke Points in the Profit Pool.")

The pharmaceuticals business provides a good case in point. In 1993, Merck triggered a wave of restructuring in the industry when it acquired Medco, the largest pharmacy-benefit manager (PBM), for \$6 billion. Other drug companies soon followed Merck's lead. Within a year, SmithKline Beecham

Choke Points in the Profit Pool



Undated engraving of the Strait of Gibraltar

When the world's economy was based on seaborne trade, the country that held the Strait of Gibraltar wielded enormous power. Because any ship hoping to enter or leave the Mediterranean Sea had to navigate the strait, control of this waterway meant control over the flow of revenues and profits to nations and companies throughout Europe and Asia. The strait was an economic choke point that helped determine the shape of world commerce.

Profit pools also often have choke points – particular business activities that control the flow of profits throughout an industry. Choke points can arise for many different reasons: the granting of a patent for a core component of a product, the establishment of an industrywide operating standard that all companies must obey, or the consolidation of control over the customer interface, to take just three examples. And, in turn, choke points can take many different forms. In the airline industry, for example, the Sabre reservation system long provided American Airlines with an industry choke point. And in the personal computer business, Intel's dominance of microprocessors has become an important choke point.

Choke points, it should be noted, do not always represent major sources of profit in and of themselves, but they do always hold enormous strategic importance. A company that controls a choke point can influence the distribution of profits among its direct competitors and even among other, more distant value-chain participants.

Much of Microsoft's business is built on the control of choke points. Its Windows operating system is a choke point for the computer industry, and its Explorer browser is emerging as a choke point for electronic commerce. In the early 1990s, when Microsoft launched its futile attempt to buy Intuit, whose Quicken software was the leading personal-finance application, it was trying to gain control of a potential choke point for the financial services industry. If consumers shift to on-line banking and investing in large numbers, the company that controls the software gateway will control a considerable portion of the industry's profit flows.

When the banking industry saw this "disintermediation" scenario begin to unfold, they rallied, however fractiously, to prevent it. They not only lobbied intensively against the merger between Microsoft and Intuit, they also moved to establish their own software gateways. In 1994, a group of banks jointly purchased Meca, Intuit's primary competitor in consumer financial-services software. Two years later, a consortium of banks teamed with IBM to form Integrion; their goal was to develop a new Internet-based banking channel. The banks knew that they couldn't prevent the distribution of financial products through home computers and Web sites, but they could at least guarantee themselves equal "shelf space" in the new financial-services supermarket. They have, as a result, limited the concentration of power in this potential profit-pool choke point.

had purchased Diversified Pharmaceutical Services and Eli Lilly had bought PCS Health Systems.

In hindsight, some industry analysts have suggested that the pharmaceuticals giants overpaid for the PBMs. Lilly, which paid $4 billion for a business with $150 million in revenues and recently took a $2 billion write-down on the acquisition, has come in for particular criticism. And it certainly makes sense to question the value of these transactions if all you look at is the cash flow generated by the PBMs. A profit-pool perspective, however, suggests that the drug companies actually received much more than their money's worth.

Traditionally, most of the profits in the pharmaceuticals industry have been generated by two activities: developing new drugs and convincing doctors to prescribe them. The industry's unique structure resulted in an extraordinarily deep profit pool for the drugmakers. Patent protection for new drugs effectively eliminated price competition, and because drug costs were largely paid by insurers, consumers were not price sensitive. Brand selection, moreover, was largely up to individual physicians, who were directly influenced by the drug companies' sales forces. In 1992, more than 85% of prescription drugs were prescribed at the discretion of individual physicians.

The physical distribution of drugs was a separate layer in the value chain, but it was a low-margin business. Drug distributors earned pretax operating margins of only about 5%, far lower than the 25% or higher margins regularly posted by the manufacturers. Even the largest distributor, McKesson, lacked sufficient leverage with either customers or suppliers to pose a threat to pharmaceuticals manufacturers.

With the advent of the managed care revolution in the 1990s, however, this picture began to change. Pharmacy benefit managers – companies that manage drug benefit programs for large corporations – began to move aggressively into the business. Seeking to control costs for their corporate clients, PBMs would, for instance, advise doctors about generic drugs that could be substituted for equivalent but much-higher-priced branded drugs. The PBMs' influence over the selection of drug products and brands – together with their direct access to information on patients' drug purchases – posed a direct threat to the established profit structure of the pharmaceuticals industry.

If the PBMs were successful in containing drug costs, they would effectively siphon off profits from the drugmakers, some of which would go directly to the clients and the rest of which the PBMs would retain for themselves. Wall Street clearly believed in this scenario. In the early 1990s, pharmaceutical-company stocks fell sharply, representing a loss of more than $100 billion in market value.

Merck's strategy in acquiring Medco constituted a hedge against the possible success of the PBMs. If profits shifted away from the drugmakers and toward the PBMs, at least Merck would control a large share – 25%, in fact – of the new profit pool. And if the acquisition helped neutralize the PBMs' power, then Merck would have protected its existing profit pool. As it turns out, the latter scenario seems to be playing out. The Medco acquisition encouraged other drug companies to buy up the other leading PBMs, which in turn led the U.S. Federal Trade Commission to step in and put restrictions on the PBMs' influence over prescriptions.

So did the drug companies pay too much for the pharmacy benefit managers? The profit-pool lens suggests they did not. By anticipating a potential reconfiguration of the profit pool, Merck and the other industry leaders were able to take action to insulate themselves from the new entrants, protect their existing sources of profits, gain greater access to patient information, and increase the likelihood that the pool would evolve in a beneficial rather than destructive way. The stock market certainly seems to see the deals in this light: Merck's market value has risen by $80 billion since the Medco acquisition, and Lilly's market value has tripled over the last three years.

When Growth Isn't Good

The leading drug companies had the resources to shift into distribution if it turned out that changes in the industry's profit pool would warrant such a move. Most companies, however, would not be able to achieve such a dramatic shift in their value-chain positioning, no matter how attractive the profit concentrations in other segments. The entry barriers are often too high. Nevertheless, the profit pool still provides a valuable lens for companies that cannot hope to expand beyond the boundaries of their current business model.

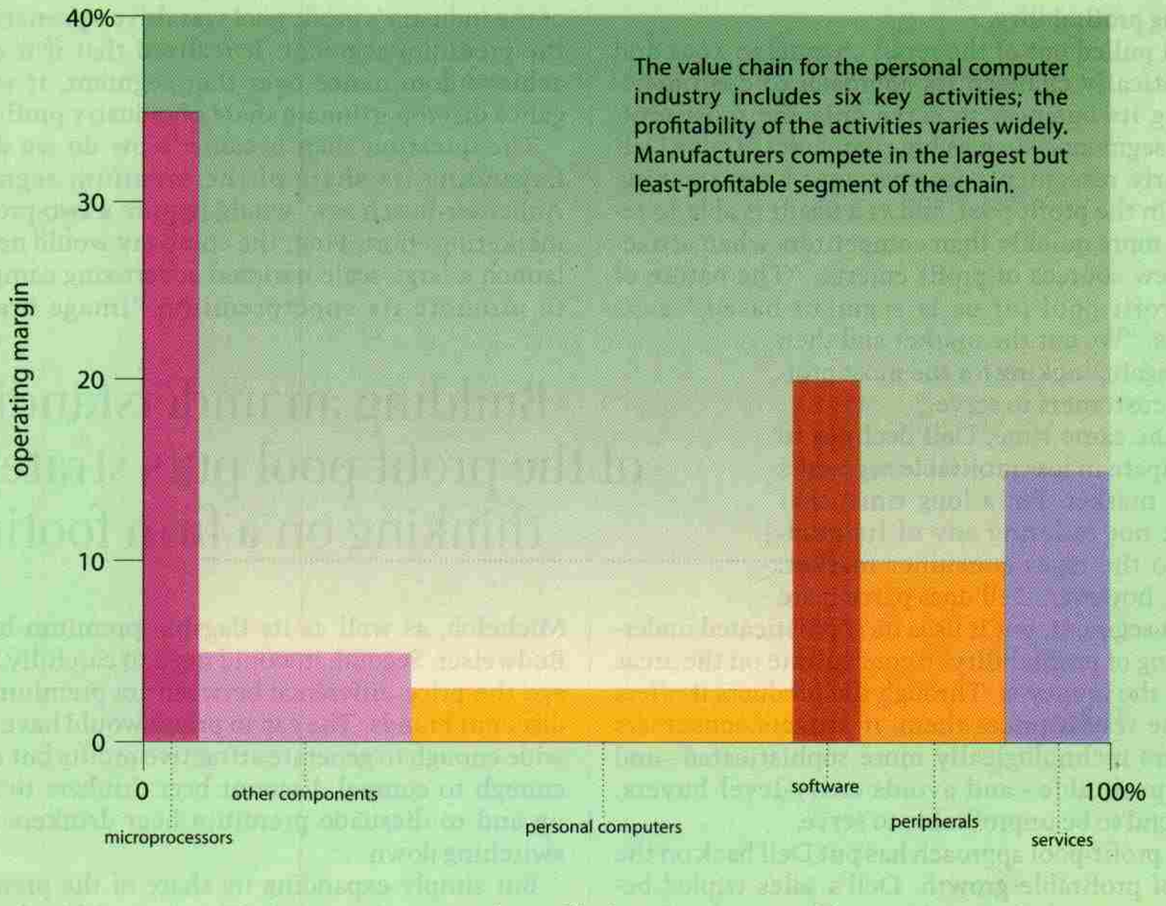
Consider the personal computer industry. Mapping profits across the value chain shows that profit is much more highly concentrated in the microprocessor and software segments than in hardware manufacturing. (See the chart "The PC Industry's Profit Pool.") Yet few if any computer manufacturers can hope to shift successfully onto Intel's or Microsoft's turf. The differences in required capabilities and competitive structure are enormous, and Microsoft and Intel have vast resources with which to defend themselves.

That doesn't mean, however, that the computer manufacturers don't have rich profit opportunities of their own. In addition to looking broadly across all industry segments, a company can also look deeply into the profit pools within its own segment, searching for pockets of profit that it can either create or mine. No market, no matter how homogeneous or narrowly defined, has a perfectly even distribution of profit. There are always products, customers, regions, or channels that yield above-average returns. The companies that recognize the variability of profit and can exploit the deepest pools will earn superior returns, even amid a sea of seemingly identical customers and products.

Look at Dell Computer Corporation. Dell competes in the least-attractive segment of the industry, the manufacturing of hardware, but from its inception in 1984 it has had a unique perspective on the industry. It built its business on a model – direct sales – that departed from the industry norm. Unlike other companies, Dell eliminated the middleman standing between the company and its customers, which allowed it to keep a portion of the dealers' profit pool for itself and to share the rest with customers in the form of lower prices.

By the early 1990s, Dell's leaders suspected that they would be unable to sustain the company's growth trajectory by relying on direct distribution alone. In pursuit of revenue growth, Dell entered the much larger (in revenue terms) retail channel. The growth strategy worked: Dell grew more than 50% per year from 1989 to 1993. Unfortunately, the company stopped making money and actually suffered losses in 1993.

THE PC INDUSTRY'S PROFIT POOL



The value chain for the personal computer industry includes six key activities; the profitability of the activities varies widely. Manufacturers compete in the largest but least-profitable segment of the chain.

What went wrong? Kevin Rollins, Dell's vice chairman, says that "Dell had lost its focus on the most profitable customer segments and on a distribution model that is at heart more efficient than what the retailer can provide."

In the face of declining profitability, Dell's executives analyzed every piece of their business to determine systematically where they were actually making money. The data showed that the retail channel was simply not profitable – not for Dell and not for most other computer companies either. Nor was there any feasible scenario under which retail would ever yield attractive returns for Dell. The profit picture was always stronger under the direct-distribution model – especially when supply chain costs were factored in – regardless of which customer segments were being served.

In addition, Dell knew that there were great variations in profitability among different segments of its customer base. When it served customers one-on-one, it was able to monitor those variations directly. But by going through indirect channels, it lost a vital conduit to its customer base. As a result, it was unable to distinguish between customers of varying profitability.

Dell pulled out of the retail channel in 1994 and dramatically changed its approach to customers, gearing its business to serve only the most profitable segments, such as big companies. Today Dell regularly resegments its customer base, tracking shifts in the profit pool, and as a result is able to respond more quickly than competitors when attractive new sources of profit emerge. "The nature of the profit pool for us is segment-based," says Rollins. "We cut the market and then cut it again, looking for the most profitable customers to serve."

At the same time, Dell declines to participate in less profitable segments of the market. For a long time, that meant not tailoring any of its products to the mass consumer market. Today, however, Dell does participate in that segment, but it uses its sophisticated understanding of profitability to concentrate on the areas where the money is. Through the products it offers and the way it prices them, it attracts consumers who are technologically more sophisticated – and more profitable – and avoids entry-level buyers, who tend to be unprofitable to serve.

The profit-pool approach has put Dell back on the path of profitable growth. Dell's sales tripled between 1994 and 1997, and its profits soared to $747 million. Its pretax margin of over 9% is more than three times the industry average, and it now controls approximately 10% of the entire profit pool for personal computer manufacturing. "When we talk to market analysts," says Rollins, "we tell them we want a bigger share of the profit pool, not more market share."

Creating and Managing a Profit Pool

In a rapidly growing industry, the profit-pool perspective helps Dell to focus and refocus its resources on its best opportunities. But what about companies whose growth opportunities are scarce? Again, by helping companies to see what their rivals don't see, the profit-pool lens can inspire strategies to create and control new profit pools, even in stagnating industries.

Consider the U.S. beer industry. Twenty-five years ago, Anheuser-Busch had an insight about making and marketing beer. Recognizing that a great disparity existed between the profitability of "premium" beers and standard (or "discount") beers – both cost virtually the same to produce and distribute, but premium brands sold for a significantly higher price – the company saw that the size of the industry's profit pool was driven primarily by the premium segment. It realized that if it could achieve dominance over that segment, it would gain a disproportionate share of industry profits.

The question then became: How do we do it? Expanding its share of the premium segment, Anheuser-Busch saw, would require a two-pronged marketing effort. First, the company would need to launch a large-scale national advertising campaign to promote its superpremium "image brand," Michelob, as well as its flagship premium brand, Budweiser. Second, it would need to carefully manage the price difference between its premium and discount brands. The gap in prices would have to be wide enough to generate attractive profits but small enough to compel discount beer drinkers to trade up and to dissuade premium beer drinkers from switching down.

But simply expanding its share of the premium segment wasn't enough. The more difficult challenge lay in protecting the segment's profitability. Anheuser-Busch wasn't prepared to make big in-

Building an understanding of the profit pool puts strategic thinking on a firm footing.

vestments to increase its share unless it could be assured that the added profits would not be eaten away by competition. It needed, in other words, to make the premium segment less profitable for its competitors, thus discouraging them from competing aggressively for the segment. The only way for the company to accomplish that goal was to build a cost advantage over its rivals. If it cost others more to produce and distribute beer, they would have less money for advertising, and they would find it difficult to undercut Anheuser-Busch's pricing.

Anheuser-Busch found the source of its needed cost advantage by looking at another element of the value chain: packaging. It saw that shifting beer packaging from bottles, the traditional favorite, to cans would produce big savings. Because cans are more compact than bottles, they "cube out" more efficiently – that is, a lot more of them can fit into a delivery truck. A brewery's scale historically had been limited by the quantity of beer that could be distributed economically by truck. By increasing the number of gallons a truck could distribute in a single run, Anheuser-Busch would be able to extend its breweries' distribution radius, which in turn would enable the company to build larger breweries with better economies of scale.

Through promotions geared toward beer retailers and beer drinkers, Anheuser-Busch was able to encourage customers to start buying beer in cans rather than bottles. At the same time, to ensure a supply of low-price, high-quality cans, the company integrated vertically into can production. The economies of scale resulting from the packaging change, together with more streamlined production processes (also made possible by the shift to cans), provided Anheuser-Busch with a substantial operating-cost advantage over its competitors.

By expanding the premium segment of the market while simultaneously cutting its manufacturing and distribution costs, Anheuser-Busch not only grew the industry profit pool, it also raised competitive barriers around the pool. Beer, long a regionally fragmented business, suddenly became one in which national scale mattered – in both manufacturing and advertising. Regional brewers, lacking scale, saw their share of the U.S. beer market shrink dramatically; many went of business. The other big national players, Miller and Coors, were unable to match Anheuser-Busch's advertising spending, making it impossible for them to compete effectively for the premium segment. And while Anheuser-Busch had shifted its focus to developing the more profitable premium customer, Miller, in particular, remained stuck in the old mind-set of focusing on revenues and unit sales.

Although Miller and Coors increased their overall share of the beer market during the 1980s (at the expense of the regional brewers), their profits stagnated. Anheuser-Busch, by contrast, enjoyed annual profit growth of more than 15% in that decade, as its share of the premium segment grew to more than 50%. Through its superior knowledge of the profit pool, Anheuser-Busch succeeded in reshaping the industry to its own advantage.

A New Set of Imperatives

Profit pools can take many shapes, depending on the economic and competitive forces at work in an industry or industry segment. And companies can use their understanding of the pool in many different ways: to identify new sources of profit in low-margin industries, as U-Haul has done; to chart acquisitions and expansion strategy, as Merck has done; to decide which customers to pursue and which channels to use, as Dell has done; or to guide product, pricing, and operating decisions, as Anheuser-Busch has done. In fact, an understanding of profit-pool dynamics can help guide important decisions about every facet of a company's operation and strategy, leading in many cases to the development of new, more profitable business models.

The profit-pool lens offers a very different perspective on an industry, especially for companies used to thinking in terms of revenues. Using the lens to formulate strategy may require the overturning of old assumptions, the rethinking of old decisions, and the pursuit of counterintuitive initiatives. A company may, for example, hold off on pursuing obvious growth opportunities in favor of concentrating first on seemingly less exciting business segments with richer profit pools. It may shed traditional customer groups, product lines, and even entire businesses in order to focus on the best profit sources. It may deliberately reduce its profits in one area of its business to maximize them in another. Even the way a company views its competitors may change. It may, for example, decide to cooperate with its rivals in order to block or take advantage of value-chain shifts that threaten an existing profit pool.

How a company puts its profit-pool insight to work will, of course, depend on the company's competitive situation, capabilities, economics, and aspirations. Building an understanding of the profit pool does not obviate the need for good strategic thinking. What it does do is put that thinking on a firm footing.

Reprint 98305 To order reprints, see the last page of this issue.