

PROFIT POOLS – ATOMS OF STRATEGY DEVELOPMENT

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“The engine which drives Enterprise is not Thrift, but Profit.” John Maynard: A Treatise on Money, 1930

ABSTRACT

This article discusses the concept of profit pools, which can be categorized into three categories: primary, secondary and tertiary profit pools. Profit pools can be assessed to maximize profit in a company. Profit pools can be combined and engineered; they can also be a base for assessing the value of a company, therefore giving new insights into the value creation of a company.

1 The Atoms of Strategy Development – The Search for Generic Profit Pools In A Global World

When developing a business strategy, that means securing the future income streams of the company (Gählweiler 1990, p.26ff), many managers focus on revenue growth, assuming that profits will follow. But that approach can be dangerous: today's deep revenue pool may become tomorrow's dry hole. To create strategies that result in profitable growth, managers therefore need to look beyond revenues to see the structure of their industry's profit pools.

So the sustainability and depth of profit pools are not only essential for strategy making, they may be vital for the future survival of the company as a whole. This brings us to the definition of Profit Pools.

2 What Is A Profit Pool - Definitions

Gadiesh and Gilbert of Bain and Company (Gadiesh/Gilbert, 1998) define an industry's profit pool as the total profits earned at all points along the industry's value chain.

Gählweiler (Gählweiler 1990, p.34ff) calls it success potentials or identified yet unsecured and unleveraged profits. His concept focuses on the difference between the current success and the future market potential a company can address.

Our definition is a little simpler and more basic: *a profit pool (or success potential) is any sustainable source of profit.* This means, buying something cheaper or selling something at a higher price than the competition (and therefore making profit). Ideally such sources of profit are magnitudes bigger than usual and allow higher margins. They should be based on a sustainable difference, not just a temporal difference. As profit is the essence of business, finding the current and future profit pools is also the essence of any strategy development. We see a profit pool more like an “atom” of profit, whereas we regard the whole value chain – according to Gadiesh/Gilbert (Gadiesh/Gilbert 1998) – more like a “molecule of profit”. We use the term *business model* for such a “molecule”. In our terminology a business model is therefore a system of profit pools¹

We think it makes sense to identify the single sources of profit in a business before we discuss and value the business model as a whole. It should therefore be possible to spot, identify and value individual profit pools (i.e. the “atoms”).

What kinds of typical or “generic” Profit Pools actually exist? We argue that a distinction should be made between primary and secondary - and even tertiary - profit pools. A primary profit pool is one that can be tapped directly with regular business development. It is a differentiation which can be exploited without preconditions. Secondary profit pools exist on top of primary profit pools and can only be accessed or developed, if an underlying primary profit pool is already there.

As an example a price arbitrage between two countries might lead directly to profitable trade transactions. We would therefore regard it as a primary profit pool. A brand profit pool on the other hand needs a solid foundation in existing business contacts and customer transactions, before the power of the brand can unfold to the company. Such a brand profit pool therefore would be regarded as a secondary profit pool. A tertiary profit pool then e.g. exists, if multiple enterprises join together to build a supply chain or consortium and harvest profit through this construct (figure 1).

<p>Tertiary Profit Pools base on secondary Profit Pools, need a partner</p>
<p>Secondary Profit Pools base on primary Profit Pools, can be accessed alone</p>
<p>Primary Profit Pools instant profit without preconditions</p>

Figure 1 – Profit pool definitions

3 Primary Profit Pools

As defined above, a primary profit pool has no preconditions and can be tapped directly by anyone. We describe some primary profit pools as follows:

Arbitrage: Different types of arbitrage can be distinguished: economic arbitrage, cultural arbitrage, administrative arbitrage, geographic arbitrage (Ghemawatt, 2004).

Economic arbitrage (Price and cost arbitrage): Differences in prices or costs belong to the most fundamental profit pools and are at the heart of trade. Economic arbitrage is centuries old. In medieval times prices for spices, salt or silk were very different between countries (price arbitrage) and these differences lead to long lasting and well established trading routes (i.e. the silk road). Modern economic arbitrage (Ghemawatt, 2004) can be found between countries, on stock exchanges around the world or e.g. in the wage differences between China and the Western World (cost arbitrage).

Often unnoticed is another type of arbitrage: the cultural or knowledge arbitrage.

Cultural arbitrage means a cultural habit or cultural difference, which is present in one country or a region and not in another. Such a difference can then be transferred and capitalized upon in another country. Different eating habits, events, customs, fashions, they all can be a source for products or services in another location. E.g. 50 years ago in Germany nobody had Italian pizza at lunch nor were Italian restaurants available. Nowadays this cultural eating arbitrage brought in by immigrant workers and the Germans' own travel experience has been developed to a point where every household has frozen pizza in its refrigerator and Italian specialties can be found in every supermarket. It has become a commodity and the former cultural profit pool has lost much of its attractiveness. Another cultural example is Halloween: unknown in central

Europe 10 years ago, Halloween has established itself in recent years. Events and accessories are marketed and sold heavily and bring nice profits (Matlack, 2004).

Knowledge arbitrage: To take the example one step further, cultural differences can be seen as experience gaps or – enhancing this concept - knowledge gaps. A pure knowledge gap example: With the collapse of the state owned planned economies in the eastern bloc in the 80's of the last century, the lack of knowledge in western business tools and business knowledge became apparent. American MBA schools started business ventures and programs in Russia and China and earned good money for a long lasting period. Therefore cultural arbitrage includes earnings from knowledge transfer as well.

Geographic arbitrage is often working on the geographic difference and taking profit out of the fact, that transportation and communication costs are usually low. A good example is the flower industry in the Netherlands, serving flower shops all over Europe and even globally (Ghemawatt, 2004).

Administrative arbitrage means to take advantage of the differences between countries in taxation, customs or legislation. A good example here is the fund industry in Luxemburg, which had in the 90's a more liberal and more advantageous tax regime than its neighboring countries. This has taken away a large portion of the fund industries from Switzerland and Germany (Dresdner Bank 2005).

The same profit pool mechanism can happen by a difference in legislation: Not every company plays by the same rules – often industry specific governmental legislation creates differences in the compliance processes. As early compliance with the regulation often is a key differentiating factor, this means, that companies that are quicker to get official approval for their products, have an important and usually lasting competitive advantage and therefore have a sustainable source of profit.

Business System Dominance: We live in an era of global giants (Bryan, Zanini, 2005) where few, yet powerful global players in the business world dominate and force suppliers and consumers to play according to their rules. Such dominance can obviously be used as a profit pool.

White Space Between Industries, Innovation: On the other hand, smaller companies can find niches or markets of underserved demand, typically by developing new business models. This means swimming in a "blue ocean" with no competitors as Chan Kim puts it (Chan Kim 2004). He argues that such niches can be large and sustainable enough to build a sound profit pool. However to make them sustainable, companies usually have to rely on the classical differentiators.

Process Advantages: Next to size and dominance in an industry – process or procedure advantages over the competition can give a distinct advantage. Since Michael Hammer introduced the term “Business Process Reengineering” (Hammer 1993, 2004), it is clear that superior processes contribute to profit and growth. A very good example for that is Easyjet (O’Neil, 2006): the reengineered check-in process with Internet sales and booking, no sales agent commission, no physical ticket and boarding card saved a fortune in the process costs, and on top of it made Easy Jet easy to use for the customers (figure 2). In the beginning this was new to the industry. However now as this practice starts to emerge as the new standard procedure, the profit pool begins to melt (Mercer 2004, p. 10).

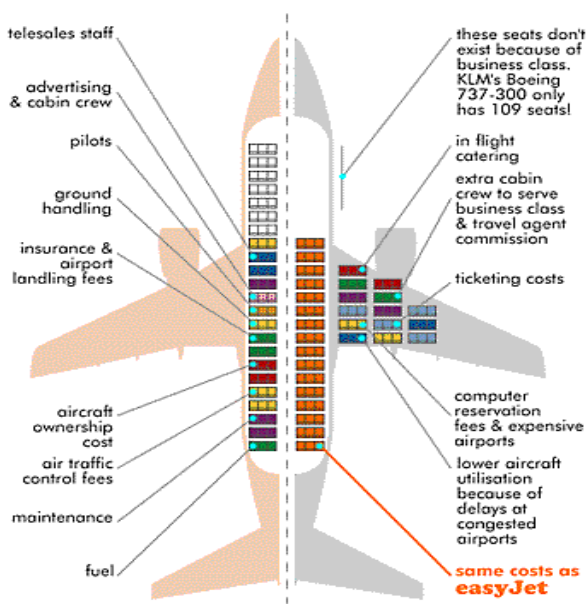


Figure 2 –Differentiating factors in the easyjet business model cited after O’Neil, 2006

(Re-) Packaging and (Re-) Labeling: Often used in the consumer industry, a new label or package with a different look and promise may allow higher prices and therefore better margins and profit. Some examples: 0.25 l of an Emmi milk drink with a nice new package cost 1.90 to 2.20 CHF (at local retail stores in Switzerland in 2006) and a standard milk package of 1 l is 1.40 CHF. The product difference is – from the cost point of view - essentially nothing. Some aromas and a new convenient packaging add only little to the bill.

Intellectual Property: This profit pool exists, if intellectual property can effectively be protected - typically by a patent. Pharmaceutical companies who discover a special formula to cure an illness and protect their discovery with a patent are good examples for this profit pool. Another example is the music and film industry with their reliance

on the label's and actor's intellectual property rights. With the advent of digital copying their profit pool is going to melt.

A particular case of the Intellectual profit pool is **technology:** Having developed a distinct and unique technology, which no other company has, is surely destined to become a profit pool – if the market and the consumers are ready to pick on that technological advantage and if the company, which owns the technology, is able to see and address this potential. A good historic example is the story of the invention of the computer mouse and the windows based operating system at Xerox Parc, who was not able to commercialize that invention. It took Steve Jobs from Apple to realize the potential of this technology with the Lisa computer, which was widely praised, yet had no commercial success due to many other reasons (Bellis 2006)).

Often technology is used to create a **system lock-in** by holding it **proprietary:** System lock-in is widely used in HiTech industries: a proprietary interface or technology with or without a technological advantage can be used as a profit pool and source of sustaining income. A good and recent example is the ipod's proprietary data interface to communicate with other devices like chargers, speakers, car audio systems etc. It is an interface like any other and nothing is special about it. Yet according to the press (e.g. Sonntagszeitung 2006) in 2007 70% of all new cars in the US will feature the Apple ipod interface. As no competitor has ever tried to achieve that, no other interface for an MP3 Player is there. This is a cleverly designed profit pool, whenever the ipod interface is in the car, the likelihood of buying an ipod for use in the car will rise, as it is so easy to integrate (plug and play). Once *locked-in in the system, switching costs are high*, so no customer even thinks about switching - locking-in therefore not only the customer, but the company's profit as well. This approach is heavily used by the software industry (i.e. operating systems) and the camera industry (SLR camera systems with lenses and other add-on devices).

On top of that, the system lock-in model can also be used for *asymmetrical price strategies*. Gillette e.g. sells its shaver at a cheap price, yet the disposable consumption good, the razor blades, are expensive (CASH 24.8.06, p.12.), securing huge profits this way. This approach reverses the traditional model where the machines are costly, yet the consumables are moderately priced.

Employees’ Skills And Know how: If one has ever been serviced badly in a hotel, bank or restaurant, one notices immediately the difference between a good service and a bad one, and the loyalty customers have to good service personnel. Good service therefore can be a lasting profit pool, if the skills, attitude and know how of the personnel can be retained in the company. A good example for the

value of the relationship and consulting skills can be found in the private banking industry. Here, when a banker changes the employer, the customers often change the bank, too. So it is in the interest of the institution to keep the valuable people and bind them to the company.

Design: There are many companies with medium to good quality products, which, from the technical point of view, are not the most advanced, yet their products feature stunning, distinctive designs. Luxury watches (Breguet, Cartier etc.), cars (BMW, Alfa Romeo, Mercedes Benz etc.), multimedia companies (Apple, Bang and Olufsen) and other industry sectors like the fashion industry are examples. The nice and different look can be used as a status symbol for customers to demonstrate their own taste or can be seen as a statement showing the belonging to a specific group. As this is a very emotional and personal issue, it usually is of high emotional value to the customer. A high price for the designed good is therefore usually not a barrier for a purchase (Moore, Fernie, Burt, 2000, p. 919-937), but rather an effective differentiator.

Unmet Customer Needs: Addressing unmet needs from customers can be another source of profit, if this information goes directly into product and service design (Stringfellow, Nie Bowen, 2004). These customer needs are difficult to get delete right yet they can't be copied too easily.

Needs And Convenience: Convenience – defined as products or services which save the customer time or space, can be a profit pool, too. The concept is used heavily in the food industry (Warde, 1999, p. 518 – 599), where i.e. pre-packaged salads are bought by customers at a higher price than the raw salad alone. The price premium is paid for the extra comfort.

Lack Of competitors: The lack of competitors meaning an oligopoly - or even a monopoly in the extreme - in a business field usually enables a nice profit pool: if nobody is in that industry, a monopoly for the company exists and the company can “dictate” the prices for the products with hardly any or no link to their cost structures (see Vesey 1992, Suarez, Lanzolla 2003, Hennaforde 2005). This usually means intransparency to the customer and may therefore be a source of sound profit. As with the market entry profit pool, the advantage may erode quickly and be more of a temporary nature if new entrants arise.

4 Secondary Profit Pools

It may be seen as arbitrary to make a distinction between primary and secondary profit pools, as both categories share the same basic concept. Yet as we defined earlier, the primary profit pools exist per se and can be leveraged alone, whereas the secondary profit pools need an

underlying structure of one or more primary profit pools in place to unfold their power.

Brands: A brand is a promise to the customer, an alerting signal and “A name, symbol, design, or some combination which identifies the product of a particular organization as having a substantial, differentiated advantage” (O'Malley, 1991, p. 107, Kotler et al, 2004 p. 291ff). Or in other words: Brands are at the heart of marketing and business strategy. If done properly, the marketing of brands delivers at its best trust and reliability to the customer, a standardized experience and quality level. Therefore a brand can secure a lasting source of profit to the company. A Big Mac (Mc Donalds has one of the highest valued brands in the world) e.g. is prepared based on the same recipe globally and is marketed the same way everywhere (Jones, Hillier, 2002). Yet prices vary widely, adjusted to the buying power of the local customers (Economist 2006). For the promise or warrant of the branded customer experience the customer is usually willing to pay a nice premium (28 to 50%, Apelbaum, Gerstner, Naik, 2003) over a similar non branded product or service.

Economies Of Scale: The “Economies of scale” approach allows a company usually to have better cost structures than competitors with lower production volumes, as the fixed costs for production are the same for higher as well as lower quantities (e.g. Roberts 2005, Ghemawatt 2004, p. 179). The result is a better contribution margin and usually better profits. Economies of scale therefore can be considered as a profit pool, too.

Early Market Entry – Speed: Being the first in the market with a new product, service or feature gives the opportunity to ask for relatively high prices as there are no other companies for comparable products (Vesey 1992). Other findings reveal this may just be half of the truth (see Suarez, Lanzolla, 2003), showing that this “time to market” approach is usually only a short window of opportunity and doesn't last long. Probably the longer lasting competences of the product design crew, the core competences (Prahalad, Hamel 1996) or the “innovation speed” of the R+D department are the real profit pools then. The launched innovation itself is then only a temporary profit, not a “pool”, i.e. a longer lasting source of profit.

Value Chain Dominance: A classic example of a profit pool is value chain dominance (Raynor, Allen 2004). If a company dominates an industry either by size or sales volume or knowledge (or all together) it may be able to dictate prices or the behavior of its suppliers (Bryan, Zanini, 2005). I.e. to become an Apple value added reseller you have to fulfill certain criteria – i.e. minimal revenue from sales, specific skills, store layout and stock inventory to name a few.

5 Tertiary Profit Pools

In our definition tertiary profit pools build on primary and secondary profit pools and can only be tapped, if the basis of primary and secondary profit pools is laid out already.

Alliances: Often neglected in business and in academic literature, alliances might be a powerful instrument to secure profits and create competitive advantage. A good example here are airline alliances like e.g. the Star Alliance, a network of many airlines spanning the globe and enabling the individual airlines to offer a complete coverage of destinations all around the globe while maintaining their competence and cost structure in the local market. Another example for this strategy is Fuji and Xerox, which share a technology and divide the markets geographically (Gomes-Casseres 2005). The advantage for the companies in an alliance is, that they can have a joint market approach, share technology and other resources and can access together a larger market, increase sales volume and profit therefore from economies of scale without the burden of having to outgrow their competitors. Another advantage is also that alliances are quicker to set up than growing a business organically into the same size.

Virtual Business Networks: Next to combining physical resources with a long term hard contractual setting, a virtual business network can be set up to secure and tap into profit pools. (Example)(Examples) can be found with code share flights for airlines, construction cooperations to do a joint project or supply chain networks around the delivery of a product like you have in the car industry. Also virtual Internet platforms like EBAY, RICARDO or Youtube (www.ebay.com, www.ricardo.ch, www.youtube.com) which bring buyers and sellers or contributors/users together fall into this category. These networks can be a good setup for accessing profit pools jointly while the network or platform alone has no value at all (imagine EBAY without buyers and sellers!).

6 Combining Profit Pools

If you have a single profit pool, to draw profit from this is a nice thing. Yet it may even be better to have several sources of profit and combine them. Take a typical drug like ASPIRIN from Bayer as an example. Bayer has a strong brand, worth a premium for the customer to pay for. Next to the brand there is price arbitrage between countries – the price in Greece is five times less than it is in Switzerland. Also we assume there is cost arbitrage – the drug is produced where this is cheap, as this increases the profits. Then there are economies of scale in drug production – the same drug content, galenics and blister packages can be used all over the world, only the local outer packaging has to be different due to governmental

regulations. Next there is the patent or intellectual property - in the ASPIRIN case not anymore, yet many new drugs have patented formulas, which often make them unique and so profitable.

As one can see in this example, the combination of profit pools is even more powerful than tapping into a single one. We therefore think it may be well worth to assess the profit pool capabilities in products, processes, structures and people to fully unlock the potential a company has. Partially this has been suggested already for assessing the value chain alone (Schmidt/Vogt 2004, Gadiesh/ Gilbert 1998). Yet we think that there may be more profit pools than just in the value chain alone, and this requires a wider scope in assessment.

7 Profit Pool Engineering Versus Business Engineering

Having assessed the actual profit pools in use and the potential profit pools a company could make use of in the future, it is useful to think about how the profit pools can be (re-) arranged to reinforce and optimize the overall profit generation capability of the company. We call such approach *business model engineering* or *profit pool engineering* (Other authors refer to this as “business insights” (Campbell 1997, p.51) and recommend that management should focus on such “insights” rather than on action plans – a recommendation which we fully support.) Yet profit pool engineering is not the same as “business engineering” – a popular discipline and collection of techniques and methods promoted by Oesterle and others (Oesterle 2003). Whereas classical business engineering focuses on the construction of processes, organizations and IT systems aligned with strategy to deliver the business mission, profit pool engineering looks for profit pools (or to be more precise: for profits) i.e. not for the methodical steps in realizing the strategy but for its focus!

Within the classical business engineering perspective strategy might be a useful tool, yet it is not a dominant one. In profit pool engineering however, strategy is the single focus. Everything else is derived from there in consequential methodological steps. Assuming the strategy is right, value creation and processes can be optimized. Within the classical business engineering approach the profit generation ability of the strategy is never challenged, whereas within profit pool engineering, profit pools need to be assessed continuously and realigned and enhanced immediately if necessary – the strategy might then follow and be updated. In other words: *profit pool engineering has the focus on value generation, business engineering the focus on efficiency and effectivity* within a given structure. Both approaches therefore enhance each other, yet they are different. They are complementary in their function.

Profit pool engineering means (re-) arranging and organizing a company - or business unit or product line - in such a way, so that the profits are maximized and optimally leveraged (figure 3). This usually means combining profit pools to maximize profit. To give an example: a company might manufacture an MP3 Player and sell it to the customers. Now the catalogue of profit pools might be checked to see what kind of profit pools could be tapped and applied. Design may be one, the economies of scale another one, stronger branding and distribution network integration may come on top of these. A detailed assessment can then deliver the chances of acceptance of the new revised business model in the market. At this stage however one should be very clear of which elements shall be designed as the key differentiators for the targeted market.

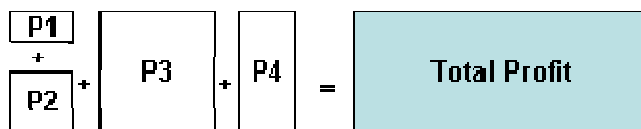


Figure 3 – Profit Pool Engineering combines different kinds of profit pools together to maximize overall profit

8 Business Strategy: How To Discover Profit Pools?

With our tour d’ horizon through sources of profit or profit pools, we have seen a vast variety of potentials to draw profit from. Yet questions arise: how do you discover profit pools and how can they be captured quickly? This is at the core of business strategy making, as strategy is defined as securing the success of a company in tomorrow’s markets. The answer may lie in the entrepreneurship skills as they are taught in many courses around the world (e.g. at Babson College, www.babson.edu).

So what does a good entrepreneur do? Yes, he identifies and realizes chances or business opportunities. And before that, we may argue, he has developed a special sensorium or scanning technique to seize these opportunities. Day and Shoemaker (Day, Shoemaker 2006, p. 49 ff) describe in detail what that means – it is opportunity scanning or active scanning of weak signals, a term introduced decades ago by Igor Ansoff (Ansoff 1981, p. 234-264, 1981.). This means, according to Day, Shoemaker, actively scanning customer needs, possible channels, emerging technologies, markets and regions, industry sector structures and business models as well as value chains, political, legal, social and economic forces, influencers and shapers (Day, Shoemaker 2006, p.53). On top of these generic scanning areas, we would argue it may be valuable to take our proposed list of profit pools and scan them in the concrete business situation:

simply check if one or more of these potential profit pools may be applicable.

If scanning means *assessing chances*, what does profit pool scanning then really mean? We think profit pool scanning starts first with identification of the potential sources of revenue. Secondly it makes sense to estimate the size of the profit pool now and in future as well as its growth rate based on customer demands and needs. Of course, if the profit pool is big and growing, this means more profit. Also the stability of the need has to be taken into account: do we see a short term opportunity only or do we see a steadier stream of demand over a longer period of time? The more stable the better, the more profit will return in total.

Another important next step is then to check, who is already addressing this profit pool in the sense of a “competitor analysis”. The fewer companies use it, the better it is in terms of competitive advantage and harvesting profits. If a profit pool has not been “discovered” by the business community yet, there is hardly any competition there and chances are good to achieve good margins from the customers. Yet strategists may then face the typical avant-garde problem: if you arrive in the market too early, the market may still be too small as customers are not yet familiar with the new product. (Day, Fein, Ruppertsberger 2003)).

9 Company Valuation Based On Profit Pool Assessment

Having done a profit pool assessment right, this gives us completely new insights with respect to the financial flows and the value distribution within a company as well as to its competitive position and its overall value. Whereas in “traditional” financial monitoring, typically revenues, cost and contribution margins are looked at, the core of value generation – the root cause for profit – can neither be observed nor put under control. This way revenues may decline suddenly, profits may fall and contribution margin may shrink without a warning nor a hint as to what could be the reason for that ?

Financial indicators are no early warning system as they are based only on historical figures. Even with a Balanced Score Card or Strategy Map (Kaplan 2004) and the construction of lead indicators, the root causes for profit declines may still be hidden behind these metrics.

For a company valuation project, we therefore suggest, to assess instead first the health or robustness of the current profit pools used and secondly to scan the company and its environment to address potential profit pools for the future. Such a profit pool evaluation of a company’s businesses will probably lead to more precise results. Assessing each business or product in terms of the profit pools used, the business model behind it (this means here the combination

of profit pools), the stability of its construction for the future and a projection of the resulting income stream based on it may give better insights than the “traditional” financial indicators.

To perform a profit pool assessment for a company valuation project correctly, we think it is necessary not only to assess the profit pools’ sizes (now and in the future), their growth rates and the exclusivity of their use, we also think the costs and the risks to address and defend profit pools need to be taken into account, too.

10 Further Research Questions

Having described here the basic landscape of profit pools and their use in business strategy and analysis, we still see some white spots on the map where further research is needed:

- Have we captured all major profit pools or are there even more to discover?
- Are there specific combinations of profit pools which will work well together and others which will probably not?
- Is the combination of profit pools a linear addition? Or is it even a multiplication? Or do we see a profit limiting curve the more profit pools we combine? Can a mathematical function be shown for the profit pool distribution? What constraints apply?
- Is there a difference between a profit pool and a success potential? Is there one between a profit pool and a competitive advantage? Is any differentiator a profit pool? – what can we see here from the point of empirical evidence?
- Are companies who design their companies around profit pools more profitable than others? Are they performing better? Do we have empirical data to support this?

These and more questions have to be researched in the future to ensure the viability and validity of this concept.

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¹ The definition problem includes the problem of classification of the term "Profit Pool" with respect to other similar terms like "Core Competence" (Prahalad Hamel 1994), Success Potential (Gählwähler 1990), Differentiation (Kotler 2004, p.574) and Competitive Advantage (Porter 1998). Whereas a core competence might become a profit pool ("=sustainable stream of (net) profit") this is not given and mandatory. We see core competence as a building block for tapping into profit pools. Success potentials are in our view quite identical with the term profit pool – with the difference that a potential has to be realized to become a real profit pool. Strategic differentiation might lead to success potentials and then to profit pools, but this is not always the case, it is – in our view - a precondition. Enterprises might have themselves set apart and differentiated without addressing such a profit pool. A competitive advantage may also lead to success potentials and profit pools, yet the competitive advantage may vanish quickly hindering delete the advantage to become a sustainable source of profit or profit pool. We think competitive advantage of a company is an early stage of a profit pool or a success potential.