



Achieving and Sustaining Superior Profits

A basic premise of strategy is that superior profits occur when a corporation secures favorable positions in attractive industries, and pursues economies of scope across business units. This note draws on research that documents the importance of industry, positioning, and corporate-parent effects on profitability. The research shows differences in the influence of the effects for high and low performers, and differences for firms that are in the process of achieving and of sustaining performance.

How Much Do Industry, Positioning, and Corporate-Parent Effects Matter?

Case studies on entrepreneurship suggest that three types of influences—industry, positioning, and corporate-parent—may be important to the *achievement* of superior profits.

- *Industry Effects.* In many situations, entrepreneurial companies enter industries that generate unusually high profits for all participants. Lotus Development Corporation's return on sales never dropped below 12% during the 1980s partly because it had entered the burgeoning PC-software industry.
- *Positioning Effects.* Companies often secure favorable positions within their industries, and defend their positions against imitation by rivals. Southwest Airlines, for example, achieved a competitive advantage in the airline industry during the 1980s by targeting business travelers with short-haul service between southwestern cities. Because conventional wisdom held that short-haul service would be unprofitable, Southwest did not attract imitation until after it had secured a strong position.
- *Corporate-Parent Effects.* In some cases, companies achieve superior profits in a particular business by capitalizing on their experience in related businesses. For example, Taco Bell's profits improved during the 1980s after the company was acquired by PepsiCo, a diversified beverage and food company with experience in other fast-food businesses.

Associate Professor Anita M. McGahan prepared this note with assistance from Research Associate Geoff Verter as a basis for class discussion. The note reflects the results of ongoing empirical research conducted by McGahan and Professor Michael E. Porter.

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Case studies also document the importance of positioning, industry, and corporate-parent effects to the *sustainability* of superior profits.

- *Industry Effects.* Superior performance may deteriorate because a company participates in an industry that suddenly suffers a downturn. The deregulation of long-haul trucking during the 1980s led to the cherry-picking of favorable routes by new entrants. As a result, profits dropped for companies across the industry.
- *Positioning Effects.* Firms sometimes lose advantage within attractive industries because competitors damage their positions. Heileman was the fifth-largest American brewery in 1980. By 1987, the company was bankrupt partly because competitors had dropped prices in Heileman's markets.
- *Corporate-Parent Effects.* A corporate parent may lead to a deterioration in the profits of a business unit that continues to occupy a favorable position in an attractive industry. During the 1980s, Ross Perot claimed that his company, EDS, had suffered as a result of its acquisition by General Motors.

A recent study suggests that on average, all three types of effects are important.¹ Industry effects account for about 19% of variation in the profitability of U.S. corporations within specific businesses. Positioning effects account for 32% of variation,² and corporate-parent effects account for 4% of variation. This study does not report on whether the effects differ in the achievement and sustainability of performance, however.

The Evolution of Profitability

The influence of industry, positioning, and corporate-parent effects shifts over time. Figure 1 shows the influence of the effects on the achievement of superior and inferior performance in 1994. To construct figure 1, McGahan and Porter categorized each business as a high or low performer based on its 1994 profitability (measured as the ratio of operating income to identifiable assets).³ The authors then calculated the average profits in prior years for businesses in the high and low cohorts. The vertical axis in figure 1 represents the amount by which the average profit in each cohort deviates from the economic mean in a particular year. Thus, the figure represents the development of high and low performance.

Figure 2 shows the influence of the effects on the sustainability of high and low performance after 1982. To construct this figure, McGahan and Porter first classified businesses as high and low performers based on 1982 profits, and then tracked the subsequent performance of businesses in each cohort. In both figures, only businesses that existed for the entire period are included. The reported averages are weighted to reflect the sizes of each business in assets.

¹ McGahan and Porter, "How Much Does Industry Matter, Really?," *Strategic Management Journal* (July 1997), pp. 15-30. The study is based on the Compustat Business-Segment Reports for 1981 through 1994. The unit of analysis is a public corporation's profit in a 4-digit SIC code (SIC codes are standard industry classifications). The dataset covers firms traded on U.S. stock exchanges. Profitability is measured as the ratio of operating income to identifiable assets.

² A positioning effect for a particular business is the amount of profit that is not attributable to the industry, to the corporate parent, or to macroeconomic fluctuations. It reflects all anomalies that are idiosyncratic to the business, including accounting conventions, reporting errors, and measurement errors.

³ The data and unit of analysis for this study are the same as in the study described in footnote 1, except that this study excludes the first chronological observation on each business. This exclusion results in the omission of all data for 1981.

Figure 1: The Achievement of High and Low Performance in 1994

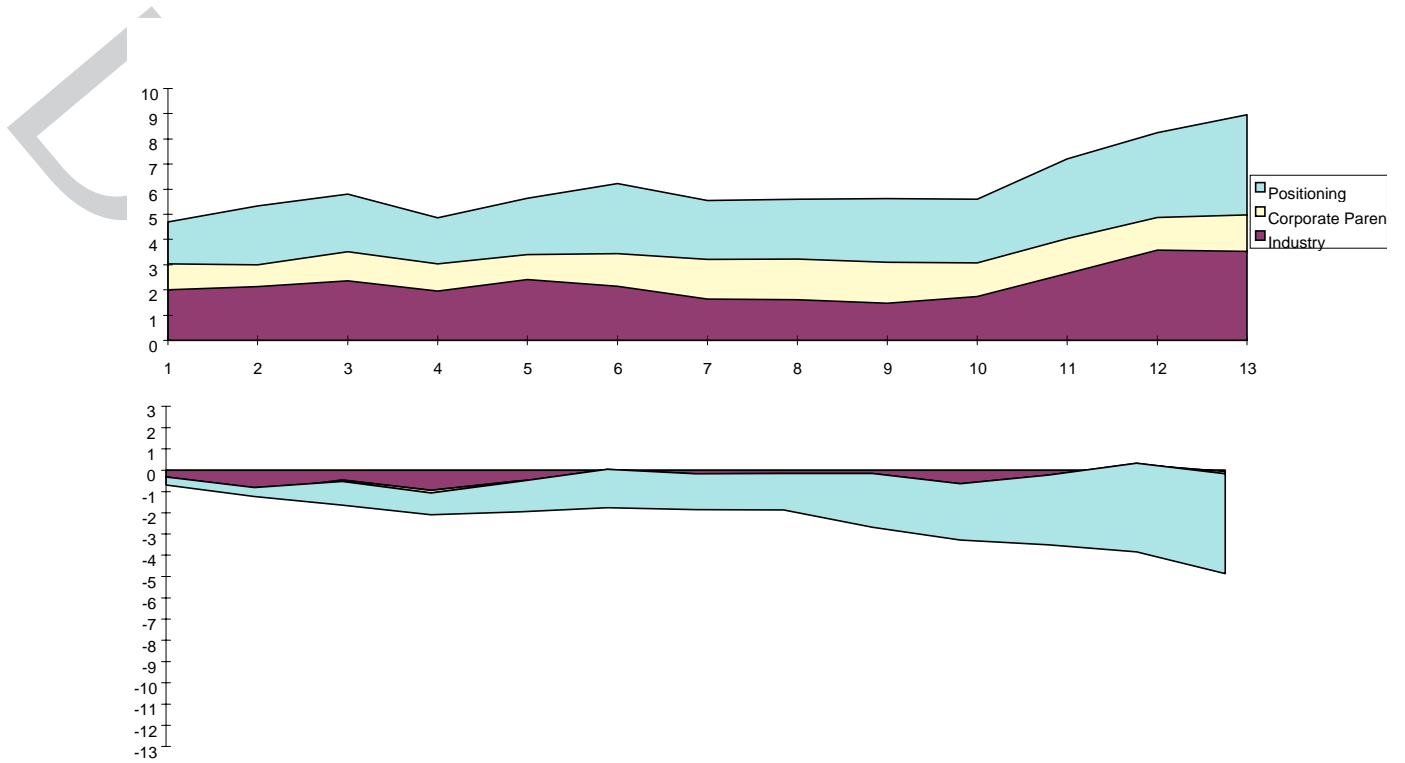
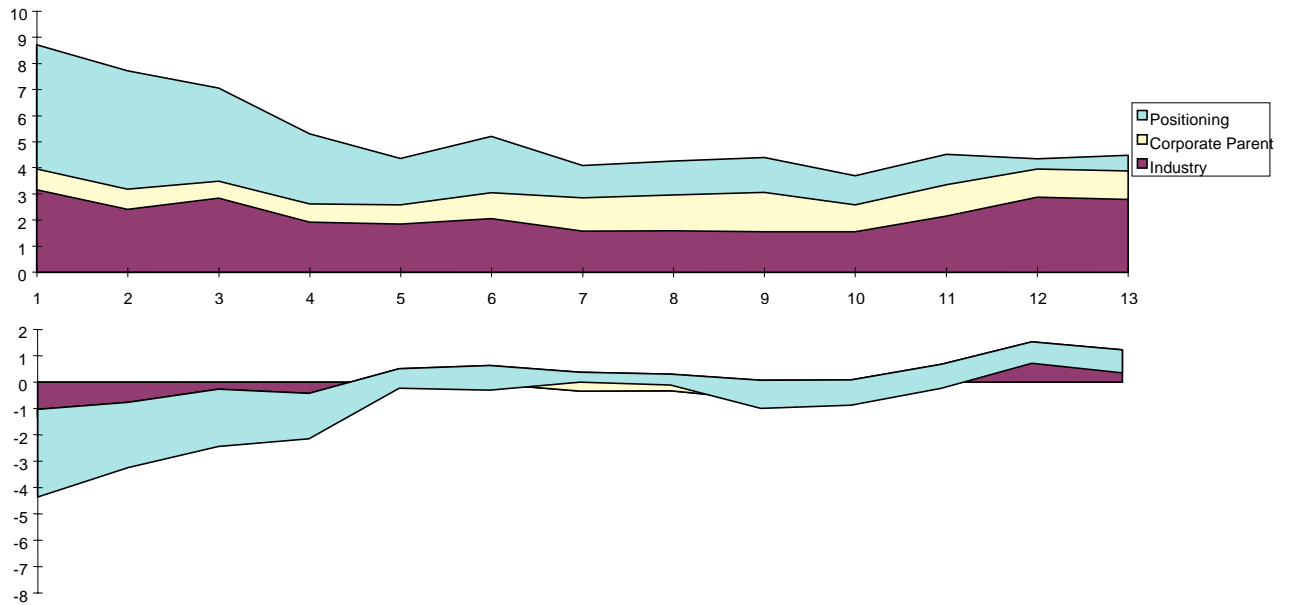


Figure 2: The Sustainability of High and Low Performance in 1982



Several important asymmetries appear in the figures.⁴

- *High performers show profits that are farther from the mean than low performers.* This asymmetry arises for two reasons. First, survivorship over the 13-year period between 1982 and 1994 is associated with higher-than-average profitability.⁵ Second, large low performers tend to show profits that are close to the mean (relative to large high performers). Because the averages are weighted to reflect the sizes of businesses, this tendency drives the averages for low performers toward the mean.
- *High performers build and sustain strong positions in attractive industries. Low performers participate in slightly unattractive industries, but their poor returns are largely attributable to positioning problems.* In Figure 1, industry effects are initially as important as positioning effects. In Figure 2, industry effects are ultimately more important than positioning effects. In both figures, industry effects persist at a high rate for high performers. For low performers, industry effects are relatively small.
- *Corporate parents were particularly important to the achievement of high performance, but had a negligible influence on low performance.* The influence of corporate parents is strikingly similar to the influence of industry effects, although corporate-parent effects are smaller on average.
- *Positioning effects are particularly important to low performance. Although positioning has an important influence on high performance, it is not as sustainable as other types of effects.* Positioning effects tend to accumulate faster than other types of effects in the achievement of high and low performance (see Figure 1). Positioning effects are also less sustainable than other types of effects.⁶

Although industry, positioning, and corporate-parent effects are each important on average, the influences vary for high and low performers. Industry and corporate-parent effects are significantly more important and more persistent for high performers than for low performers.

⁴ McGahan and Porter confirm the highlighted asymmetries for years other than 1994 in “The Emergence and Sustainability of Abnormal Profits,” Harvard Business School manuscript (May 1997).

⁵ The means in figures 1 and 2 are calculated with reference to all businesses for which the authors have data. Businesses that survived over the entire period (represented in the figures) tend to have higher profitability than the general average.

⁶ A paper by McGahan and Porter called “The Persistence of Shocks to Profitability,” *Review of Economics and Statistics* (Spring 1999), confirms this result analytically.