THE FOUR SOURCES OF CORPORATE PROFITS

Why are some companies profitable? It is a fundamental question and yet few executives have good answers. Nor did we.

Then we stumbled on Richard Makadok's paper on the topic, "The Four Theories of Profit and their Joint Effects", from 2011.[i] Brilliant.

The view among academics is that there are four sources of profits:

Source: Richard Makadok (2011): *The Four Theories of Profit and Their Joint Effects*, Journal of Management

- **Competitive advantage**: Companies can systematically transform inputs in a more productive fashion than competitors (often, but not always, through scale economies), thus generating sustainably superior profitability. Current examples include Nvidia, Apple, and Walmart.
- **Reduced rivalry**: In some industries, competitors choose not to compete on price (in a legal manner) because low prices is not what customers value the most. Examples include professional services, and health care, but also fast-moving consumer goods: Coca-Cola and Pepsi is a good example.

- **Information asymmetry**: Some companies have an information advantage over customers, generating profits without having a competitive advantage. For example., used car dealers (see Ackerlof's Nobel Prize on the market for lemons), stock brokers, and airlines.
- **Commitment timing**. Companies can enter a new market at the right time and have a first, second or late mover advantage: any point of entry is possible under the right circumstances.

  Amazon was the first mover in online retail; Tesla in electric cars[ii]. Examples of late entrants are Apple with the iPhone and Alphabet with Google Search, and Boeing in civilian aircrafts.

These profit sources interact, and when companies combine them, they earn superior and often sustainable profits. Makadok discusses these interaction effects thoroughly, but it is a topic for another **Quick Read**.

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[i] Richard Makadok (2011): *The Four Theories of Profit and Their Joint Effects*, Journal of Management, vol. 37, no. 5, pp. 1316-1334. Available at https://journals.sagepub.com/doi/pdf/10.1177/0149206310385697

[ii] Nissan entered many years earlier but in a small way and without credible commitment.