



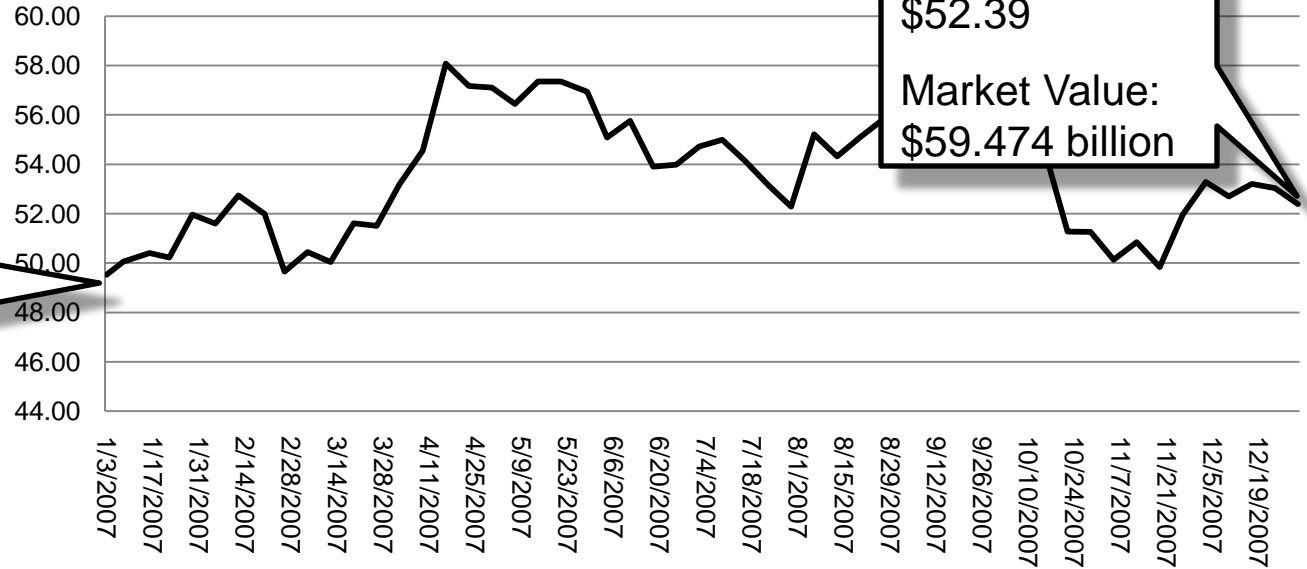
**Rose-Hulman Institute of Technology**  
**Department of Humanities & Social Sciences / K. Christ**  
**SV351, Managerial Economics**

## 1-1: Normal and Abnormal Profits



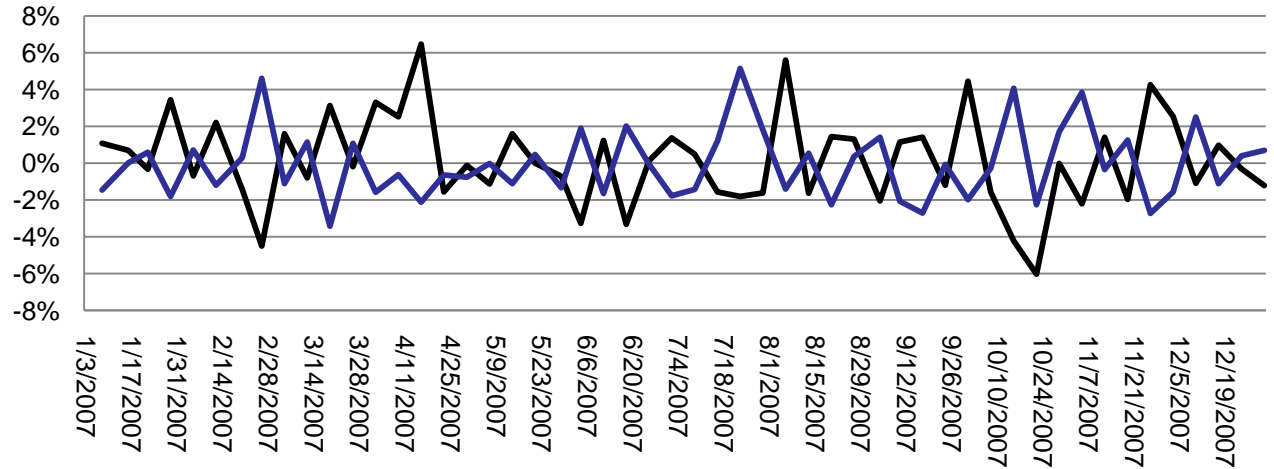
Stock Price:  
\$49.52  
Market Value:  
\$56.216 billion

Lilly Stock Price



Stock Price:  
\$52.39  
Market Value:  
\$59.474 billion

Weekly Returns



— Lilly Weekly Returns      — S&P 500 Weekly Returns

# *To What Do We Attribute “Abnormal” Returns?*

<b>Returns Comparison</b>					
	Lilly	Abbot	Pfizer	S&P 500	12-mo. T-bill*
Annual:	5.80%	15.22%	-9.56%	4.16%	4.98%
Weekly:					
Average	0.11%	0.27%	-0.19%	0.08%	0.09%
Std. Dev.	2.49%	2.75%	2.45%	1.92%	0.00%

\* Rate on January 5, 2007

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# *Economic Analysis of Market Opportunities*

## **Sources of *abnormal* profits in competitive environments**

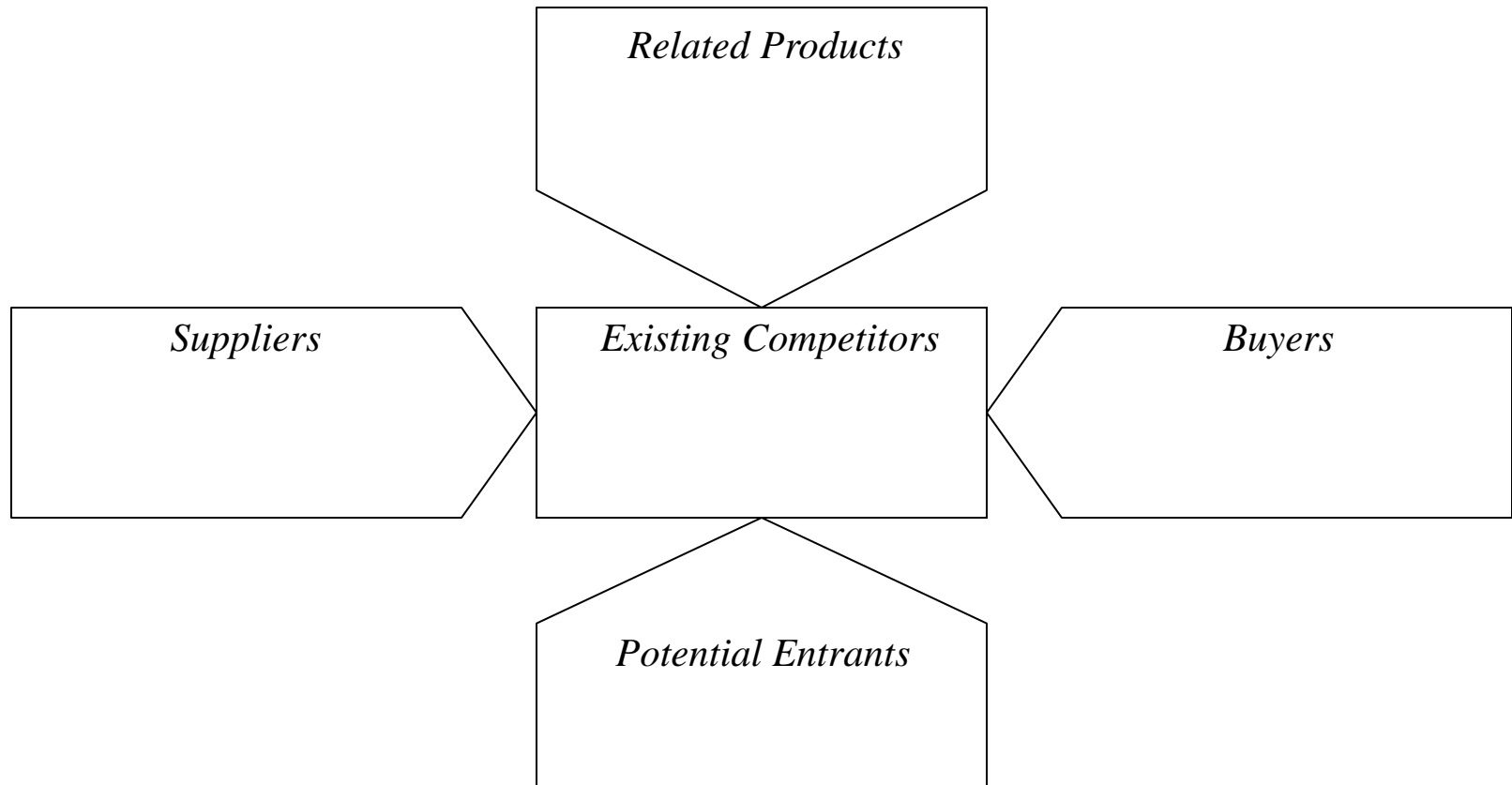
The theory of competitive markets predicts a tendency for abnormal (or positive) economic profits to be ephemeral. Thus, if one observes abnormal profits, one should ask:

- ❑ Is the profit real, or a result of measurement error?
- ❑ If the profit is real, is it a payment for risk taking, and if so, should the profit estimate be adjusted to reflect the costs of bearing that risk?
- ❑ If the risk-adjusted profit is real, then \_\_\_\_\_, and \_\_\_\_\_?

# *Economic Analysis of Market Opportunities*

## **Sources of Value in competitive environments\***

In evaluating business opportunities, it is useful to systematically evaluate the likelihood of persistent and defensible positive economic profits. Michael Porter's "five forces" framework is one approach to such an evaluation:



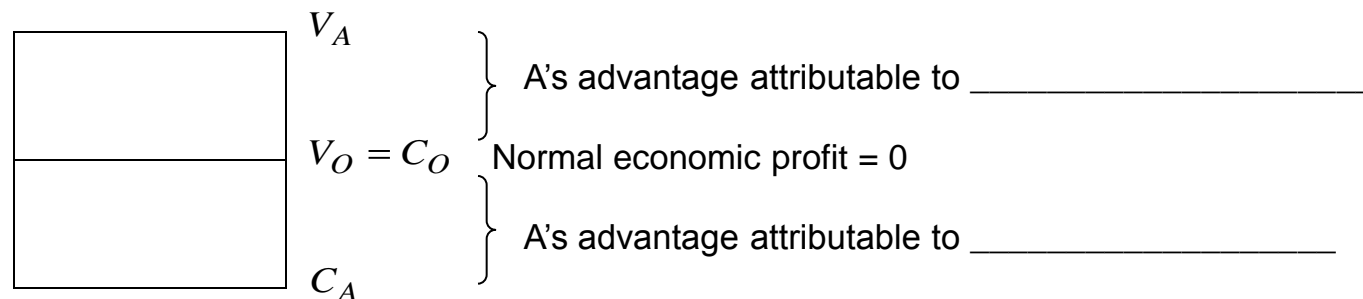
\* Adapted from Michael E. Porter, "How Competitive Forces Shape Strategy." *Harvard Business Review* 57:2 (March-April 1979), 137-145. Also see Porter, *Competitive Strategy* (1982), and Michael Baye, *Managerial Economics and Business Strategy* (6<sup>th</sup> ed., 2009), 8 – 11.

# *Economic Analysis of Market Opportunities*

## **Sources of value in competitive environments\***

Another perspective on the sources of abnormal profits are *product differentiation* and *cost efficiency*. This may be summarized graphically\*:

Where:  $V_A$  = Value of firm A's product or service to the consumer  
 $V_O$  = Value of average competitor's product or service to the consumer  
 $C_O$  = Average competitor's economic cost of production per unit  
 $C_A$  = Firm A's economic cost of production per unit



\*Adapted from Sharon Oster, *Modern Competitive Analysis*, 3<sup>rd</sup> ed., especially chapter 7.

# *Economic Analysis of Market Opportunities*

## **Sources of abnormal profits\***

- ❑ ***Market Power***: Excess returns may result from exploitation of a protected environment where entry is difficult.
  
- ❑ ***Entrepreneurial Activity***: Excess returns may be attributable to an ability to anticipate and rapidly exploit new opportunities.
  
- ❑ ***Organizational Advantage***: Excess returns may result from possession of a sustainable competitive advantage over potential and actual rivals.

\*Sharon Oster, *Modern Competitive Analysis*, 3<sup>rd</sup> ed., 27 – 28.