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PROS AND CONS

WHAT IS SUPERNORMAL PROFIT?

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IN micro economic theory, there is a term called supernormal profit. The term itself defines what it is — profit above the normal level.

The superlative "super" merely adds to there being a windfall profit.

Another definition of supernormal profit is all the excess profit a company makes above the minimum return necessary to keep a company in business.

Conversely, normal profit is defined as the minimum level of profit necessary to keep a company in that line of business. This level of normal profit enables the company to pay a reasonable salary to its workers and managers. It is, in short, the normal profit earned by a company.

Thus, supernormal profit is defined as extra profit above that level of normal profit. The challenge with earning supernormal profit is that it provides an incentive for other companies to enter the industry. And they can enter the industry easily if the barriers to entry are low.

Supernormal profit in perfect competition

The theory of perfect competition suggests that supernormal profit can only be earned in the short term. In the long term, firms will make normal profits. This is because other entrants will increase supply and erode the supernormal profit. With perfect competition, there will be two things: freedom of entry and exit, and perfect information.

A good example in recent times is the supernormal profit enjoyed by glove companies when the Covid-19 pandemic raged and ravished health and lives. There was a sudden and huge increase in demand for gloves, but supply was rather limited.

Basic economic theory states that when demand outstrips supply, prices will increase, and prices did increase in the form of increased ASP (average selling price) of gloves.

The supernormal profit enjoyed by the glove companies must have been the envy of many other companies both locally and internationally. Locally, a few public-listed companies announced their venture into the glove business. This announcement alone drove their share prices up. Internationally, China was getting ready to flex its muscles and flood the market with gloves given their availability of human resources and their enviable time-to-market.

They were prepared to undercut mercilessly — and so they did.

Malaysian glove companies suffered as a result. Their supernormal profits were whittled away to normal profits.

All glove companies ended up being punished with below supernormal profits. Some smaller players have sunk into the red recently.

There is one factor that contributed to the rapid levelling of supernormal profits — barriers to entry. It is estimated that it takes as short as six months to set up and operationalise glove production lines. Additionally, rubber gloves are a commodity business (easy to copy) with little to no differentiation. With more new players joining the fray and existing players also expanding production capacity, supply eventually outstripped demand and resulted in rapid declines in the ASP.

Contrast this with the situation faced by palm oil companies. Large-scale plantation land is scarce and it takes about three years for a freshly planted oil palm to yield FFBs (fresh fruit bunches).

However, the yield is relatively low at this stage and remains so until year seven. It is only at year seven that the tree reaches peak production. The barriers to entry are higher and the gestation periods are longer.

The recent fall in crude palm oil (CPO) price by about 50 per cent from its peak of about RM8,000 per tonne in early March (based on Bursa Malaysia CPO futures contract for spot month September) were due to wide-ranging factors:

- Rising palm oil exports from Indonesia (following Jakarta's move to flush out palm oil inventories accumulated since March);
- Improved supply visibility on major vegetable oils;
- Rising stockpile in Malaysia on higher output and lower exports;
- Easing concerns on labour shortage in Malaysia;
- Seasonal uptrend in the palm oil output cycle; and,
- Recent aggressive interest rate hikes by the United States Federal Reserve that have dampened overall market sentiment.

But the increase in CPO supply was not due to companies hastily planting oil palms and harvesting the FFBs and, consequently, flooding the market. Shareholders should appreciate this discerning difference. Not all super profits are created equal — at least in terms of the risk of new entrants to the market.

However, most markets don't have these features of perfect information and freedom of entry and exit.

Most markets have a degree of barriers to entry and exit. There are set-up costs that deter entry. Therefore, even if firms are making supernormal profit, new firms may not be able to enter and compete as the set-up cost is simply too overwhelming.

Pros and cons of supernormal profit

The pros are:

- Firms can use supernormal profit to invest in research and development and enhance its first-mover advantages through better innovation.
- Governments can collect windfall tax from the supernormal profit. But this can be a con, depending on which side of the equation you stand.
- Enables firms to build up reserves to survive economic downturn — the "war chest". Acquisitions, mergers and diversification become a possibility.
- Potential special dividends to reward shareholders.

The cons are:

- If supernormal profit is gained from monopoly power, it represents a transfer of income from consumers to owners of monopolies. This is allocatively inefficient.
- Very profitable firms like Apple and Google often have difficulty to usefully reinvest profit. Hence, they develop large cash reserves, representing unused resources.

So, the vulnerability of supernormal profit can be due to barriers of entry or how easily competitors can enter the industry.

According to investment guru Warren Buffett, this is the "moat" that discourages new entrants into a particular industry and by extension, protects companies in that industry.

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